Office of
Tax Simplification

Review of partnerships: interim report

January 2014

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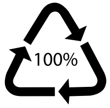

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Foreword

Partnerships are probably the simplest way that two or more people can get together to run a business. This way of running a business is very old, and the law governing it dates back to the Partnership Act 1890, which defines a partnership as “the relation which subsists between persons carrying on a business in common with a view to profit”. This Act was followed by the (lower profile but still used and relevant) Limited Partnerships Act of 1907, but it was then almost a century before the next major piece of partnerships legislation arrived in the Limited Liability Partnerships Act of 2000.

Partnerships are a significant part of the UK economy. HMRC records suggest partnerships account for around £150 billion of turnover a year. Around 10 per cent of UK businesses are partnerships. The majority are small businesses, with 55 per cent having business turnover under £75,000. But there is a significant group of slightly larger businesses – 41 per cent of partnerships have turnover betwen £75,000 and £1 million – and then a relatively small number of large businesses operating as partnerships. The major professional firms are the most obvious manifestations of large partnerships but many ‘City’ financial arrangements are conducted through this practical mechanism, especially in relation to property investment and venture capital.

The tax system can struggle to cope with partnerships, mainly because there is no formal partnership tax system. One has never been designed: at times it seems that partnerships can be an afterthought (or not thought about at all) when it comes to new tax laws. The general ‘lookthrough’ system of not taxing the partnership, but the partners each being taxed on their share of the profit, works tolerably well but it creates problems in practice, especially when partners leave or join and in international situations. Another problem is the “one size fits all” nature of the tax rules for partnerships. The same basic rules apply for Mr and Mrs Smith (grocers) in exactly the same way as they do to PricewaterhouseCoopers LLP and also the structure funding a major property investment. Those designing the 1890 Act – which has stood the test of time pretty well – probably didn’t imagine companies being involved in partnerships, something that happens today in many fields.

Some people we spoke to wondered why partnerships needed to fill in a separate tax return when they don’t pay tax themselves. An investment partnership involving many non-resident partners wonders why each partner has to file a tax return. Others thought it unfair that a late partnership return doesn’t just incur the normal £100 penalty, but each partner gets a £100 penalty. We’ve heard about problems with partners’ expenses, with stamp duty land tax and VAT and also had many interesting discussions about the arcane world of capital gains tax and HMRC’s Statement of Practice D12.

Since we started this project in late summer 2013, our small team has been busy going out and about talking to individual firms, tax advisers, HMRC staff and representative bodies about partnership tax complexities. We were ably assisted by our Consultative Committee of experts, who gave us very helpful support and advice based on their wide experience.

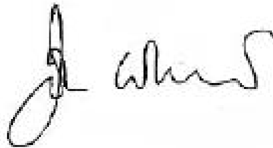
Our overall conclusion is that partnership tax works, but like a comfortable old shoe it is a little worn at the edges and may have a couple of holes coming through. In many ways there is a need for a variety of types of shoes – both small and large. We have some immediate thoughts which are listed in this report. There are a range of things we’d like to explore further, though in some of these we have ideas/directions.

We'd like to focus the next stage of our project on small partnerships – what can we do to make life easier for them? Is there a better way for HMRC to handle their tax affairs? Why should they have a bigger administative burden than similar sized businesses that are not partnerships? At the same time we want to look at things that might help larger businesses: more technical issues such as stamp duty land tax and some international tax issues. We'd like to start the next stage in April and report back by the summer with firm proposals for simplification in these further areas.

Finally, our sincere thanks are due to Roger Jones, Martin Gunson and Gareth Jones, who wrote this report, and to all the people who gave so willingly of their time to speak to us, including a large number of HMRC teams. Thank you!

Rt Hon Michael Jack

Chairman
Office of Tax Simplification



John Whiting

Tax Director
Office of Tax Simplification

Executive summary

Key themes

The key themes emerging from our work are:

- **The "one size fits all" approach of partnership tax leads to extra burdens and complexities for small partnerships, when compared to sole traders with similar sized businesses.** Whilst we recommend a few short term fixes in this report, we would like to explore some more complex issues in the next stage of our report. Specifically, we would like to focus on how we could reduce the burden to small partnerships of filling in a partnership tax return. We are particularly interested in exploring with HMRC what opportunities **HMRC's digitisation programme** presents for administrative simplifications.
- **The tax system needs to take a more strategic approach to partnerships.** Tax policy and administrative processes have generally been designed with sole traders and corporations in mind, with partnerships less obviously being a focus. This is despite partnerships making up 10 per cent of UK businesses with combined sales of £150 billion, with significant presence in the UK financial services sector. This problem extends to international situations: tax treaties do not always consider partnerships as much as they should and there can be a lack of understanding of partnerships in the UK's international trading partners.
- **HMRC needs to coordinate its partnership work and support properly.** HMRC does not have a partnerships customer directorate, nor does it have a senior civil servant with sole responsibility for partnerships across the range of all taxes. This is in contrast to how HMRC handles trusts, pension schemes and charities, all of which are less prevalent than partnerships. HMRC's guidance on partnerships is difficult to find as it is not in one consolidated place. Partnerships currently cannot file their return online with free software, unlike other businesses. When taxes apply to partnerships they often involve special calculations, but HMRC does not currently have a single contact point where partnerships and their advisers can go for the specialist advice they require. Overall HMRC treats partnerships as groups of customers with varying business needs instead of focusing on the partnership as a whole. Lack of resources has made this difficult to do; where resource has been applied, HMRC have produced excellent results, such as with their Large Business Service team and Large Partnerships Unit.
- **One of the most sensitive issues we have encountered in our project has been the question of the stance of HMRC towards partnerships, especially LLPs.** We were told in many external meetings that HMRC generally treat partnerships, and LLPs in particular, as if they were exclusively avoidance vehicles. Echoes of this came in some of our meetings with HMRC staff, though at senior levels HMRC are categoric that this is not the case. The debate over the anti-avoidance provisions relating to partnerships (see the comments in our introductory chapter) may well have had a part to play in this, as they were clearly in the minds of many commentators. At the same time, the views expressed by partnerships and agents were deeply felt and were clearly long-held. There is a need for balance here and our point above about

a more strategic approach to partnerships, in effect demonstrating that partnerships are indeed viewed as 'legitimate commercial structures and the majority do not…manipulate business profits', may well help reassure relevant businesses and help develop better relationships and balance.

- **Partnership tax rules are spread out across legislation and HMRC guidance** – we have illustrated this in Annex E, which lists mentions of partnerships in primary tax legislation; however there is little desire for a consolidated taxes act for partnerships. It was generally felt by stakeholders that partnerships legislation, although disjointed, actually worked. The idea for a consolidated partnerships tax act was welcomed in theory but not in practice, as it would lead to duplication and an even longer tax code. It is interesting to note that the Law Commission and the Law Commission of Scotland carried out a very extensive review of partnership law,[1] which looked to updating the 1890 Act so as to make it a clearer default code of practice. A powerful argument can be made that the 1890 Act of itself already fulfils that role.

Fundamentally, HMRC and the tax system generally needs to evolve a more supportive and constructive approach to partnerships. They represent 10 per cent of UK businesses; the very large partnerships are a major contributor to UK business and export earnings. Yet they are very much the poor relation in the way they are handled by HMRC and indeed regarded by government. Partnerships have no ability to retain profits as working capital;[2] non-corporate partners have not benefitted from the corporation tax rate reductions (partly paid for by cuts in capital allowances that affect partnerships as much as any other business); there are allowances they do not receive.

This is not a plea for an entirely separate tax system and tax management procedures for partnerships. Since the majority of partnerships have similar features to other businesses, many provisions which work for sole traders and companies will work for partnerships. It makes sense for government to focus on provisions which benefit all businesses rather than just 10 per cent – but at the same time, that 10 per cent is a significant enough proportion to warrant consideration as part of any change.

We must also balance the above comments by acknowledging the very real avoidance problem HMRC faces with partnerships and LLPs in particular. To hear of a supposed partnership with 20,000 partners shows something of the problems HMRC faces. As with all of tax, there is a balance to be struck.

Short-term fixes

We set out a number of 'short term fixes' below. These have emerged during our work as offering useful benefits, mainly for small firms, for modest effort on the part of (mainly) HMRC:

- BIS to re-publish their model partnership agreement;
- publishing a manual of consolidated guidance for partnerships;
- let interest on income be entered in gross on short return;

[1] Law Commission report no. 283

[2] Unless of course the partners agree not to distribute a proportion of the profits which they will nonetheless have to pay tax on.

- changing the corporation tax self assessment return to include a section for income from a partnership;
- HMRC to clarify when partnerships are eligible for entrepreneurs' relief (particularly regarding possible relief on subsidiary companies held by an LLP);
- the process for issuing unique taxpayer references to foreign partners needs to be streamlined;
- it would be useful to have a form of general remittance basis investment relief for groups of non-domiciled individuals investing in UK investment partnerships;
- HMRC to create free software for the smallest partnerships;
- HMRC guidance should be clearer on stamp duty land tax (SDLT) liabilities following changes in profit sharing ratio;
- there needs to be a review and update of the guidance on inheritance tax for partnerships;
- HMRC to clarify their requirements as regards limited partnerships and joint ventures for the purposes of VAT registration, where the present published guidance seems unclear; and
- HMRC to give clear guidance on VAT grouping for LLPs.

The manual of consolidated guidance and free software for small partnerships in particular would provide substantial simplification for small partnerships. HMRC has already taken the first steps towards developing these products, for which it should be commended.

Longer-term areas of focus

Below we have set out longer-term issues. These have been divided into two sections:

- those where we think there are fairly clear ways forward in the medium-term to simplify tax systems and procedures; and
- areas where there is clearly a problem in need of simplification but where the solution is not clear-cut. We have indicated some possible routes where we can but these areas warrant further investigation and testing to lead into firm recommendations.

Medium-term recommendations

These are matters that we recommend should be taken forward, presumably through formal consultation, in the near future:

- HMRC's Statement of Practice D12 for capital gains of partnerships should be tidied up to reflect modern-day business practice;
- the requirement for all partners to sign form VAT 2 needs to be removed or (probably) advantage needs to be taken of digital procedures to finesse a cumbersome requirement and eliminate duplication;

- VAT penalties for failure to notify a change from sole trader to partnership status need to be changed so that there is no penalty where no tax is lost, except for a repeat failure;
- HMRC needs to work more on ensuring double taxation agreements fully deal with partnerships;
- we think that tax returns for partnerships can be simplified by simplifying basis periods for non-trading income for partnerships, probably by being able to sweep small amounts of interest or property income into trading income;
- penalties for partnerships around late filing of the partnership return need to be reviewed with the aim of making them fairer and easier to administer. Linked to this would be a review of appeal rights of partners;
- there is a need to ensure developing business structures e.g. nested partnerships are dealt with by the tax system. The best way to do so may be a permanent HMRC/HMT/business liaison group to develop solutions on how to properly tax emerging business structures;
- we think the law on gift aid should be changed to allow partnerships to claim relief, paralleling companies; and
- we think that there is a strong argument for an equivalent to s105(4)(b) IHTA to be available for partnerships, as this reflects how such entities are being used.

Long-term areas to investigate

- how can smaller partnerships be better educated about their obligations?
- can the default partnership agreement in the 1890 Act be updated and publicised to apply in the absence of a formal agreement?
- we would like to review how best to apply the Annual Investment Allowance to mixed member partnerships without introducing complex anti-avoidance rules.
- is there a way of reducing the administrative burdens faced by small partnerships? The aim would be to eliminate what can be double reporting of the same income figures. One possible route would be to remove the partnership return. A further discussion of this can be found in Chapter 2.
- allowing partners to claim personal expenses would be a substantial simplification for many firms. During a further review we would like to explore this issue in more depth, including testing HMRC's concerns more closely.
- we would like to research further the international administrative and technical issues faced by partnerships so as to develop a list for taking forward.
- there is a need to review further the complexities caused in opening years by basis periods and overlap relief to assess whether a simpler method of giving overlap relief would be sensible, fairer and appropriate. (This would also be relevant for sole traders.)

- what circumstances, if any, would trigger a stamp duty charge on partnerships; whether these are necessary or whether it would be possible to abolish stamp duty in relation to partnerships.
- should there be a formal rule in SDLT that no tax will apply in partnership reorganisations unless cash changes hands?

Digitisation

There is clear scope for HMRC's digital exemplars to offer simplification for partners and partnerships in terms of providing a simpler way for partnerships to file. In one sense this is similar to sole traders and companies – allowing e-filing and developing systems that allow direct filing from accounting systems.

The additional scope for partnerships is with streamlining the processes for filing partnership (i.e. business) figures and partners' individual figures (i.e. the allocation). Potentially a single return of income could cover all aspects, saving taxpayers time but also providing HMRC with better audit trails.[3] There may be particularly useful savings of administration around partnerships involving overseas residents.

To facilitate digitisation, some technical changes may be helpful, for example:

- allowing 'other income' (e.g. bank interest) to be swept into the general partnership computation and assessed on the same time periods;
- simplifying opening and closing years and overlap relief; and
- reviewing what returns need to be made by overseas partners in investment partnerships.

Digitisation may also facilitate individual partners' expense claims, without HMRC feeling they are losing control or increasing their administrative burdens. It should also solve some of the issues around penalties that we have heard a great deal about.

These possible changes are all issues that we consider later in this report, irrespective of digitisation

[3] As we note later in this report, HMRC do not routinely tie up data from the partnership return with the figures provided by the individual partners for all partnerships but would do so as part of a risk assessment procedure.

1 Introduction

1.1 This is the interim report for the OTS project on partnerships. It is a summary of what we have heard from people in our travels around the country, speaking to members of partnerships, their advisers, representative bodies and significant numbers of HMRC staff. We have held nearly 50 meetings and spoken to close to 1,000 people about the issues in this report. What follows is their views and experiences, collated by the experts on the OTS team with guidance from our Consultative Committee. The points made can be taken to have been made by many people; we have made it clear if a point has only been raised by one or two consultees.

1.2 Our remit for the review was to report on areas of complexity and recommend priorities for further in depth review. However, we have also highlighted some possible short term fixes. We have made these suggestions where we think they could make things simpler without legislative intervention, or where a lot of people have commented on a particular area. In some of the more significant or longer-term areas, we have some definite ideas of the likely direction of (simplification) travel and we note these probable routes, without necessarily framing them as formal recommendations.

1.3 It is important to remember that the OTS itself can only make recommendations. It is up to the Government to decide which of these to take forward. We expect the Chancellor to give a formal response to this report in his 2014 Budget.

1.4 The main aims of this report are:

- to report back on what we have heard (so have we missed anything? Have we got anything wrong?); and
- to prompt further thought and input over the coming months as we take forward our wider areas.

1.5 Although we have held a lot of meetings and already heard from hundreds of people, we always welcome feedback on our reports and further input for our next steps.

Box 1.A: Tell us your thoughts

We would be very interested in people's thoughts on the issues we highlight in this report.

We'd also like to know if there's anything important you think we'd missed, or if we've got something wrong.

You can email John Whiting and the review team at OTS-partnerships@ots.gsi.gov.uk.

We'd be grateful for your input at any time but if there are things we have missed (or got wrong) that input would be ideally with us by the end of February 2014. Comments on the areas we note for further work should be sent to us by 31 March if possible; alternatively we would welcome offers of meetings with groups of businesses or representative bodies to discuss some of these issues.

Our remit

1.6 The terms of reference for the review proposed that we should undertake a comprehensive review of partnership taxation, including the legislation and administrative processes that are in place. In particular our terms of reference asked us to look at:

- specific tax legislation relating to partnerships;
- the administration of partnership taxation including filing of returns, payment of tax and penalties;
- the HMRC guidance relating to partnerships;
- all the different taxes, including (but not limited to) income tax, capital gains tax, inheritance tax, corporation tax, national insurance contributions and stamp duty land tax; and
- the complexities surrounding the large number of different types of partnerships.

Current anti-avoidance proposals

1.7 Our remit does not include the two anti-avoidance measures announced in the 2013 Budget, targeted at salaried members of limited liability partnerships (LLPs) and profit and loss schemes in mixed member partnerships, now taken forward by the 2013 Autumn Statement with draft legislation published on 11 December 2013. It also does not include the measure on compensating adjustments in partnerships using service companies announced on 17 September 2013.

1.8 We have however received a significant number of comments on the new proposals. Some questioned why the OTS was undertaking its partnership review at a time when HMRC were clearly planning significant changes to the taxation of partnerships. Would it not be better for the OTS to wait for the new rules to pass into law and then review them as part of the overall exercise?

1.9 We think we are correct carrying out our review now, but we cannot ignore the views we have heard about the new measures. Although many people we spoke to thought that the measures were justified in terms of the expressed aims, many think that the measures go much further than is necessary for anti-avoidance purposes. We have had a flurry of further comments, channelled through our Consultative Committee, following the Autumn Statement. The main concern revolves round the measure aimed at corporate partners: the belief seems to be that HMRC are proceeding on the basis that the only reason for the inclusion of a corporate partner in a partnership is for avoidance reasons. As we have found, this is certainly not the case: we discuss this in Chapter 3 in the context of agricultural partnerships. HMRC have been at pains to stress that they do not see such structures as solely motivated by avoidance. Indeed, HMRC have noted in their consultation response document published on 10 December 2013 that "partnerships including LLPs are legitimate commercial structures and the majority do not… manipulate business profits, losses or assets in ways that reduce their tax liabilities".

1.10 As we have said, it is beyond our remit to consider formally these new measures. HMRC have consulted on them widely and have no doubt heard the points we have on the proposals (and many more!) and will have evaluated them carefully as part of the consultative process. We do think that the point about the business reasons for involving corporate members is fair: it chimes with other evidence we have heard around the way partnerships are treated as something of a poor relation in the design of the tax system, a theme we develop in subsequent chapters.

Our approach to gathering evidence

1.11 The report is based on intensive work carried out by the OTS from September to November 2013. It incorporates feedback from nearly 50 meetings, conferences, sessions and seminars we have conducted around the country (see the list in Annex B), written comments we have received, as well as comments from our Consultative Committee of experts (whose details are in Annex D).

1.12 We have talked to a very diverse range of groups during our review, from the National Farmers Union to the Alternative Investment Management Association. We've focused much of our review on tax practitioners, from the smallest to the very largest firms and have tried to speak to firms across the country. Our review into partnerships has taken us from Edinburgh to Brighton and from Norwich to Cardiff. It has included talking to a wide range of HMRC teams who deal with partnerships.

1.13 We have also conducted extensive research into partnership tax legislation and HMRC forms and guidance, and have looked at different approaches taken by overseas jurisdictions (see Annex C).

1.14 We are very grateful to HMRC's analytical teams who responded to our request for statistics on partnerships with some very useful data and information, taken from HMRC's computer systems. This is set out in detail in Annex A.

1.15 To reiterate the point made in paragraph 1.1, this report is based on what we have been told. We have not carried out any formal survey of partnerships or their advisers and so cannot report in terms of X per cent of partnerships say Y. But we are confident that what we are reporting is well founded and represents the views of a lot of people with experience in this field. This includes the views of HMRC operational staff in many areas. We are very grateful for the time people have given us and the way they have been so willing to discuss matters.

Structure of the report

1.16 Our report covers the three main types of partnerships – general partnerships, limited partnerships (LPs) and limited liability partnerships (LLPs). In general the tax treatment for these three types is the same, but there are one or two important exceptions. We also have regard to some more specialised situations – for example, partnerships involving companies as well as individuals, and 'nested' partnerships, which are LPs or LLPs that are themselves members of partnerships. Unless otherwise specified, 'partnership' in this report can be taken as referring to all of the three main types of partnerships. 'Partnerships' also refers to non-UK entities classified as partnerships for the purposes of tax law.

1.17 The status of a partnership in Scotland is different from in the rest of the UK, a Scottish partnership having separate legal status. Our report also covers Scottish partnerships and we have endeavoured through our contacts and discussions in Scotland to ensure we have had proper regard to Scottish matters. We are particularly grateful to Alan Hartley, a member of our Consultative Committee, in this regard.

Partnership type	Legislative Act	Special features
General Partnership	Partnership Act 1890	All partners have unlimited liability for the firm's debt
Limited Partnership	Limited Partnerships Act 1907	Only the general partner has unlimited liability. Other, 'limited' partners are not able to take part in managing the firm
Limited Liability Partnership	Limited Liability Partnerships Act 2000	All partners have limited liability

1.18 As is usual in our reports, any references to the masculine should be taken as applying equally to the feminine and vice-versa.

1.19 As we were writing the report it became apparent that we were dealing with three (or possibly four) different groups of business, with widely varying business needs:

- the **small, two or three-person partnerships** did not usually encounter technically complex issues. However, they had a problem with awareness and faced an administrative burden disproportionate to their turnover;
- the **largest partnerships** had technically complex issues to face, but had access to specialist advisers (often in-house) and HMRC customer relationship managers, and were good at working constructively with HMRC to find a solution; and
- finally, there were **medium-sized partnerships**, which had relatively complex affairs which required specialist advice, but had less ready access to technical specialists. In the initial stages of our study we were not sure that these businesses were different from the two obvious extremes but as time went on it became apparent that they do have issues of their own.

1.20 For the purposes of the review, we have defined the sizes of partnerships below, although the issues which each group faces are not strictly unique to that group there may be smaller partnerships which face international issues or large partnerships with a disproportionate administrative burden. More information can be found on this in the 'Small Partnerships' chapter.

Partnership size	Small	Medium	Large
Turnover	<£250,000	£250,000-£1million	>£1million
Number of partners[1]	3 or less	4-20	>20

1.21 The fourth type of partnership is the investment business, typically investing in property that is being developed or as venture capital. These tend to be specialised, often 'City' based, often with a large proportion of the partners based overseas. They are attracted to the simplicity of the partnership entity; the partnership is often (in tax terms) in business but not trading. As might be imagined, they have some specialised issues.

1.22 We have structured our report around these different sizes of business. The report begins with a short summary section on each of these partnerships and the difficulties they face; the specialised partnerships are included in the large partnership chapter, though not all such businesses will be 'large'. We then go into more detail of the complexities in the main areas of the tax system – **income tax, HMRC administration, capital taxes and VAT**. At the end of each of these chapters we have recommended our priority areas for further review, as well as a number of **short-term fixes** which could be implemented without legislation.

1.23 Structuring the report in this way means there is some duplication of comments. This is inevitable as we have tried to make each of the various sections broadly complete in itself. We hope it does not detract from the report.

What is a partnership – and why partnerships?

1.24 Many readers will know a good deal about partnerships and why and how they are used commercially. However, in a report of this nature we should try and include some general outlines of what forms of partnerships exist. We also need to say something about how

[1] We have determined partnership size primarily by turnover; however, the number of partners could also be used and as Appendix A shows, there is good correlation between turnover and numbers of partners – as might be expected.

partnerships are used in the 21st century, although one of the main points to note is how this old trading format has still plenty of relevance today – indeed it is becoming more relevant and useful in many ways.

1.25 The OTS's paper is in Annex F.

Some overriding issues

1.26 As part of this introductory chapter, we want to comment on some general, overriding issues.

A partnership tax act?

1.27 The legislation for partnerships dates back to the Partnership Act 1890. While we have received several comments on the 1890 legal definition of "partnership" and how this causes complexity, this legislation is not the responsibility of HMRC but the Department for Business, Innovation and Skills (BIS). Non-tax matters are beyond the remit of the OTS, so we have not addressed them here.

1.28 There is no general partnership tax code, or partnership tax act. We have asked at most of our meetings whether introducing one would be a good idea. The general view can be summarised as 'Yes in theory, but no in practice'. The reasons include:

- yes: codification, would improve certainty, better recognition for a major part of the business sector; and
- no: size of the task, upheaval on its introduction, amount of work needed to change.

1.29 Overall, we conclude that there is no real appetite for such a move. Although it does have the potential to deliver codification and so some simplification in the long term, it would be a major project, consume considerable resources on all sides and cause much disruption and uncertainty. It does not therefore seem worth pursuing.

The importance of partnerships to UK plc

1.30 Partnerships are a major part of the UK's business community. As the statistics in Appendix A show, they comprise almost 10 per cent of the total number of UK businesses. They generate considerable amounts of business, including significant amounts of international financial activities.[2]

1.31 However, we have heard many times the view that partnerships are treated as something of a poor relation when it comes to tax changes. It is questionable how much they are considered when significant changes are considered. To give one example: the recent significant reductions in corporation tax rates do not benefit partnerships, because of course they are not companies. Yet the reductions in rates of capital allowances that have to some extent paid for the cuts affect partnerships.

1.32 The government's aim of developing a (or the most) competitive business tax system focuses on corporate business tax. While that is understandable, we wonder if partnerships have been properly factored into the framework. This is something we may well return to in the new

[2] The obvious examples are the major accountancy and law firms, equivalent in size to many multi-national corporations but note must also be made of the way partnerships are used as investment vehicles, often on an international basis. They are a significant contributor to the operation of the 'City' and so to the wealth creation of the UK.

project that the Chancellor has asked the OTS to undertake on the competitiveness of the UK's business tax system.[3]

1.33 As will be seen in a number of places in this report, we think there is real scope for partnerships to be considered in a more positive way in the tax system.

Profit retention

1.34 There is a significant business issue that we have heard regularly from partnerships and their representatives. That concerns profit retention – a factor that equally affects sole traders.

1.35 It is the nature of a partnership that profits are automatically allocated to the partners and the income tax system naturally proceeds to tax those profits. Some partnership agreements may provide for a certain element of profit retention for the purposes of meeting working capital requirements but this is difficult when the partners are being taxed on the income. Many have suggested that there should be a way of retaining profits in the partnership, on a pre-tax or low-tax basis.

1.36 To a degree this is a partnership law point rather than a partnership tax point. Some will also respond that a partnership that wishes to retain profits can choose to operate as a limited company, or simply choose not to distribute some of the profits. This is clearly a major issue and it would require a significant change in law and practice to address. We do note that the driver for bringing a corporate member into a partnership is often to give a vehicle for retaining profits for working capital at a lower tax cost.

[3] Terms of reference for this review can be found at https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263812/OTS_review_of_competitiveness_of_UK_tax_admin_final_TORs.pdf

2 Small and medium partnerships

2.1 As we expected from our previous work on small businesses, there was a strong theme coming out of the meetings we held that small partnerships find the tax system particularly difficult.

What is a small partnership?

2.2 Early in our research, it became clear that problems we were being told about did not apply universally; rather they applied to certain types of firms. Which problems applied to which firm mostly corresponded to a partnership's size.

2.3 This led into a debate on how business size should be measured in this context. If we were to look at number of partners, the overwhelming majority of partnerships have to be regarded as small. Almost 96 per cent of partnerships have four partners or fewer; 90 per cent have three or fewer partners.

2.4 An alternative approach that we considered was the turnover of the business. A first thought was to look at the VAT threshold (currently £79,000 per annum). This has been used to define small in other contexts, notably the cash basis for calculating trade profits.[1] By this measure, as some 55 per cent of partnerships have a turnover below £75,000, at least that proportion would be below this figure and would be regarded as small. We developed the theme and took turnover of below £250,000 as the cut off point.

2.5 Most small partnerships operate a single trade e.g. plumbing or a retail shop and many of them are family businesses. For the most part, excepting perhaps occasional isolated transactions, their taxation affairs will be simple.

2.6 Size does not completely correspond to complexity – there will be small partnerships that show complex features. In much the same way, there will likely be large partnerships with relatively simply affairs.

2.7 The OTS has used turnover as a rough guide to determining the size of a partnership and the complexity of affairs faced by such partnerships. There will naturally be some crossover investment partnerships may have no trading turnover but high income from investment; the nature of their investor profile can make their affairs complex.

2.8 Our conclusion is that we do need to split the partnership population for our work and that doing so by turnover amount is the best route. Such a split will not be a rigid demarcation: but a 'small' partnership will generally be one with two or three partners (or four where some of the partners at least are family members).

Statistics on small partnerships

2.9 We have been struck by the statistics we have received from HMRC on small partnerships:

- 10 per cent have no turnover;

[1] See section 17 and schedule 4 Finance Act 2013.

- 33 per cent have turnover under £30,000;
- 55 per cent have turnover under £75,000; and
- 79 per cent have turnover under £250,000.

2.10 It is also surprising to see how many of these small partnerships **do not indicate on their SA tax return that they** have an accountant or tax adviser:

- 32 per cent of partnerships with turnover under £30,000;
- 20 per cent of partnerships with turnover between £30,000 and £75,000; and
- 13 per cent of partnerships with turnover between £75,000 and £250,000.

2.11 It has been difficult for us to find ways to speak to small partnerships themselves, although we were given access to the results of a 2011 survey by the Federation of Small Businesses (FSB). They surveyed 242 partnerships, of which 63 per cent had four or fewer partners. In addition, it should be borne in mind that many of the agents we spoke to in the groups we met through bodies such as the CIOT, ICAEW, ICAS and AAT[2] are themselves operating as small partnerships.

2.12 OTS analysis of the FSB results suggests that:

- income tax was felt to be the most complex area for partnerships. 54 per cent of partnerships in the survey said that income tax was difficult. 72 per cent said it was time consuming;
- Partnerships were much more likely to think income tax was complicated than other small businesses[3];
- VAT, PAYE and NICs were thought to be less complicated;
- only 24 per cent of partnerships in the sample filed income tax online compared to 40 per cent of sole traders;
- partnerships were more likely to rate HMRC's clarity in communicating as poor compared to sole traders. They were also less likely to rate HMRC as "very good"; and
- one preferred area for simplification favoured by partnerships in the sample was to allow all forms to be completed and submitted online (33 per cent).

2.13 The OTS carried out a review of small business tax in 2010-12. One of the main recommendations of that review was to introduce a simpler cash basis for the smallest businesses. In response, the Government introduced new rules which apply from April 2013 to businesses with turnover under the threshold for VAT registration, currently £79,000. Essentially, these rules allow small businesses to opt in to a form of cash basis, and to claim flat rate expenses for certain items such as use of home. Partnerships also qualify for this regime.

2.14 However, it is too early to say whether these changes are making a difference. In our review we have not duplicated the work we did before, but have tried to focus on extra burdens that partnerships face over equivalent sized sole traders.

2.15 It is also worth noting the customer experience data we have received from HMRC. The data was drawn from HMRC's Customer Survey which measures customer experience (of dealing with HMRC) in 2012-13 and covers a random, representative sample of SME businesses. The

[2] The Chartered Institute of Taxation, the Institute of Chartered Accountants in England and Wales, the Institute of Chartered Accountants of Scotland, the Association of Accounting Technicians.

[3] HMRC have told us that this finding contradicts their own customer survey data, which shows no significant difference between partnerships and other small businesses.

conclusion of the customer experience survey differs from that of the FSB's – the survey found no significant differences in the customer experience of partnerships to that of a sole trader. However, both sets of data used different sample definitions which means the results are not directly comparable; the FSB data included accountants who would have used the agents helpline and included several larger partnerships whereas the HMRC Customer Survey covers agents in a separate survey and takes a representative sample of SME businesses according to size of business. The results from the Customer Survey found no difference in ratings of customer experience in dealing with HMRC between SME partnerships compared with sole traders or compared with SMEs overall.

The partnership return

2.16 All partnerships need to file a tax return, as do all the individual partners. In one sense this is the same as a company filing a return and then all its senior employees also filing returns – but in many cases not all such employees will file returns. Thus we have examined whether there is scope to streamline the partnership return process. HMRC estimates the total burden of the partnership return form alone on businesses is over £111 million (i.e. some £250 per return). Half of this burden falls on businesses with no employees, only partners – £55 million shared among 337,000 businesses[4] (the average burden is £163). The burden for businesses with 1-9 employees is £40 million, shared among 105,000 businesses (average burden £381). A significant part of these costs was fees from accountants: for nano businesses (those with no employees), this made up £52 million of the burden. These numbers don't include the cost for partners filing the SA104 supplementary pages (see Box 2.A below).

2.17 One of the biggest simplifications available to partnerships has been the introduction of three-line accounts, which, much like sole traders, allow partnerships below £79,000 turnover to file using only the partnership's turnover, expenses and taxable profit. Partnerships with an agent may still be charged for such a return, though.

2.18 Many people we spoke to questioned the need for a separate partnership return, at least for the smallest partnerships. On the other hand, most advisers to large partnerships we spoke to thought it was a useful way of getting an overview of the partnership, and was a necessary process to calculate the business income and pre-empting HMRC enquiries.

Box 2.A: Partnership returns

Each partnership is required to fill out a number of forms to complete a return. The whole partnership must file an SA800 partnership return with supplementary pages if the partnership is reporting income from savings or property. Each partner must also file a SA100 tax return with additional SA104 pages containing information on their share of partnership income.

2.19 However, the partnership return is not strictly necessary for declaring and paying tax under self assessment. Each partner has to complete their own self assessment tax return, which declares their share of the partnership profit. This is added to their other income and taxed at the appropriate rate. If partnership returns were not submitted, HMRC would still have all the information they needed to calculate how much tax is due from each partner.

[4] These figures were calculated using a different method and at a different time to other partnerships data. There may therefore be a slight difference in the number of self-assessment forms in the analysis.

2.20 There are two reasons for retaining the partnership tax return – to help HMRC's tax compliance efforts, and to provide HMRC with information about the partnership business, including gains and losses from all sources[5]. The typical compliance risks that HMRC is interested in are:

- omitted or understated takings;
- fictitious or overstated expenses; and
- "ghosts" or "moonlighters" – people who are in business but haven't told HMRC.

2.21 For the first two risks, a partnership should be no greater risk than a sole trader. There are no differences in the tax rules for what is taxable income or allowable expenses for a partnership as opposed to a sole trader.

2.22 There is a risk that one or more partners in a partnership is a "ghost" or "moonlighter", i.e. they do not declare their share of the partnership profit, or declare a lower figure than they should.

2.23 In theory, this risk is reduced by the partnership tax return, which requires a partnership to state the names and tax references of each partner, and the taxable profit due to each.

2.24 Some people have told us that if the partnership return was abolished then this would not be a real saving in administrative burdens. Partnerships need to prepare accounts and tax computations to arrive at the correct taxable share of profit for each partner. Putting the correct figures on a partnership tax return is surely not much of an additional burden. The only savings that could be made would be savings for transcription time.

2.25 However, filing an extra return does bring additional burdens as the HMRC figures show. In addition, the return generates its own bureaucracy with notices to file, reminder notices, and possible penalty notices. HMRC's own admin burden model indicates an average cost of £163 for the very smallest partnerships with no employees, for agent costs alone.

2.26 It does not seem appropriate to recommend simply abolishing the partnership return. However, we have heard too often that for small firms it adds costs to no useful purpose. Our current view is that the return could become optional for small firms, with no requirement to formally submit it if the information needed by HMRC can be provided in other ways. Small firms who have an agent acting for the firm and all the partners have suggested that they can easily provide the income details on the partners' returns.[6]

2.27 The partnership pages of self assessment returns submitted by partners (SA104) could be modified to include additional boxes indicating the percentage share agreed among the partners for that basis period, and the other partners could be identified in the white space to ensure all the partnership profits have been taxed correctly. This could be done for partnerships with relatively simple affairs only e.g. only income from savings, or only income from trading.

2.28 The OTS proposes to look into this issue in more detail in the next stage of our review, aiming to come up with workable recommendations that balance HMRC's need for information with the minimum necessary burden on businesses. As we have noted in the introductory chapter, digitisation would be one way of achieving this.

[5] We discuss the extent of HMRC's routine cross-checking of the partnership return to partners' individual returns in Chapter 5.

[6] HMRC have expressed concern about the possible abolition of the requirement for a partnership return, pointing out that '...the partner returns their allocation of the partnership profit which is calculated at the partnership level...HMRC should be able to ensure that the partners' allocations reconcile with the partnership profit that has been declared on the return, otherwise we cannot be sure that the entire profit of the business has been taxed correctly.' The OTS recommendation is on the basis that the information about the partnership profit and its allocation can easily be included in the separate partners' returns. We are well aware that HMRC does in principle need to be able to cross-check figures for compliance purposes. Our basis for our recommendation is that agents of small firms have repeatedly told us that the necessary information can be provided without going to the trouble of filling out and processing a separate return; we would also note that for firms without an adviser, it is not possible to submit that return electronically using free HMRC software.

2.29 There is great enthusiasm for the ongoing digitisation project, as it presents an excellent opportunity for HMRC to build tax collection processes properly around taxpayers in a truly customer-centric fashion. However, it is clear that full implementation is some time away. Changes need to be made sooner rather than later if the business environment is to be improved, and HMRC's costs are to be reduced. Consequently, there remains the need to make changes to the existing system. In the longer term, and linked to the digitisation project, HMRC may find that other countries may have adopted practices and forms and software from which they could learn and possibly emulate, thus avoiding reinventing the wheel.

HMRC guidance

2.30 Another issue for small partnerships is the difficulty of finding simple guidance. Both professional firms and HMRC noted that partnerships do not generally have specific tax legislation (unlike corporations), so the legislation often has to be supported by guidance and practice. This can cause difficulty to both the taxpayer and the adviser, as well of course to HMRC themselves. Apart from the additional time cost, the main problem – perhaps the key problem – is the lack of consistency that can result. We have heard a number of instances of differing firms operating differing tax rules, accepted by HMRC.

2.31 An attempt has been made to create a consolidated manual of all the applicable law and practice, which could save an immense amount of error and confusion, and the related costs. This is, we understand, something that HMRC have put significant work into with the aim of publishing in due course. We think that funding released to complete this project would be money well spent.

2.32 Some HMRC compliance officers estimate that the majority of the smallest partnerships do not have a partnership agreement. A model partnership agreement for simple partnerships detailing their obligations and profit sharing ratios which could be readily accessed and used would be helpful. BIS used to have such an agreement on their website but it was withdrawn.

2.33 The default position in the absence of a partnership agreement is that the provisions of the Partnership Act 1890 will apply, although few partnerships appear to be aware of this. We have discussed in many of our meetings the possibility of having a default partnership agreement – presumably an updated version of the 1890 Act's provisions – that would apply unless displaced by an actual agreement. As noted this is strictly the case already so we think the way forward would be:

- review and update the 1890 agreement; and
- make sure it is well publicised and easily available.

2.34 We would be interested in further views on this issue.

Online filing

2.35 HMRC's free online self assessment filing software does not extend to the partnership return. Consequently, many small partnerships that are unrepresented are obliged to submit a paper return to a shorter deadline. This is undoubtedly a factor in the calls we have heard for abolishing the partnership return where the information can be easily included in the partners' own returns.

2.36 HMRC have informed us that software is available for only £5, but we have been unable to find any commercial software available at such a low price, and no stakeholders we talked to outside HMRC about it had of it.

2.37 As the "Digital by Default" strategy is rolled out further by government, HMRC will need to consider fully the position of partnerships. As we have alluded to already, we think that digitisation offers great scope for streamlining the return processes around partnerships.

Lack of understanding

2.38 There appears to be a lack of understanding by many partners of how they are assessed and there is a great deal of confusion between profits and distributions. We suspect that this may be a factor in the mismatches HMRC encounter.

2.39 The poor accessibility to guidance only exacerbates matters. Guidance that is already on the HMRC website can be difficult for a layman to find and understand.

2.40 This is not an issue that is capable of easy solution on its own – though it does illustrate the need for simplification of partnership tax generally. Partners should not be confused about such issues. That said, perhaps it is an inevitable issue which digitalisation can sidestep or mask.

Box 2.B: Partnership profits versus drawings

This details a common mistake made by small partnerships.

A and B are in partnership on a 50/50 basis and make profits of £50,000. A has drawings of £30,000 from the partnership and B has drawings of £20,000 from the partnership. The taxable amount they are both charged on is in fact £25,000, regardless of the amounts drawn (often incorrectly thought of as a wage).

Medium partnerships

2.41 In the next chapter we talk about large partnerships. At one stage we were of the view that there would be a divide between large and small firms, with nothing in between. However, we've heard from a number of sources about a distinct group of medium sized partnerships, with turnovers between £250,000-£1million, that face particular problems. In terms of numbers of partners, these would typically have 4 – 20 partners and as Annex A shows comprise around 5 per cent of firms.

2.42 These partnerships are too small to have dedicated tax staff, though many will have some in-house finance resources. They are large enough to present problems e.g. they are likely to periodically admit new partners, which can trigger capital gains tax and stamp duty land tax charges as partnership interest and profit sharing ratios change, as well as creating opening year income tax issues, including overlap relief.

2.43 One of the main problems is purely practical. We heard of one medical practice with 20 partners, most of whom had different accountants acting for them personally. The accountant responsible for the partnership tax had to communicate with many different firms of accountants when preparing the partnership tax return.

2.44 This is a particular issue when individual partners incur business expenses such as travel or use of home. Strictly these should be included in the partnership tax computation, but it can be delayed while one or more partners are chased for the necessary information. This issue of partners' expenses is explored further in the chapter on income tax.

2.45 Another problem is the way HMRC is set up to deal with partnerships. The largest partnerships are dealt with in two specialist offices, where each gets their own "customer relationship manager", a named individual who looks after the tax affairs of the partnership. For

the largest partnerships, the partners' tax affairs are handled by a separate individual on the same team. Non-UK resident partners are still dealt with separately.

2.46 This level of service just isn't available for the vast majority of mid-sized partnerships, even though they may encounter similar levels of complexity. We were told of one accountant who rang the HMRC agent helpline to ask a technical question about partnership tax, and he was handed from pillar to post until the call ended up with the London partnerships unit. It would be much easier if there was a dedicated partnership tax unit to which these calls could quickly be sent.

2.47 A firm with just individual partners may use the annual investment allowance (AIA) to obtain enhanced capital allowances on certain capital expenditure, though this is being reduced to modest levels in 2015. However, the rules for AIA are themselves complex and exclude partnerships with corporate partners – a feature of a good number of farming arrangements, to give one area. We discuss this AIA issue further in paragraphs 3.5 and 3.6.

Simplification

2.48 Below we have detailed areas for simplification and further examination for smaller partnerships:

Short term fixes

- HMRC to publish a manual consolidating all partnerships guidance;
- develop free software for small partnerships to file online; and
- republish the BIS updated 'model partnership agreement' which partnerships can use.

Longer term areas for the OTS to explore

- How can smaller partnerships be better educated about their obligations; is there merit in developing and publicising a default partnership agreement?
- Can the default partnership agreement in the 1890 Act be updated and publicised?
- Can the partnership return be made optional – perhaps with conditions such as all partners being dealt with by the same tax agent?
- How can digitisation provide a simpler way for partnerships to file?

3 Large partnerships

What is a large partnership?

3.1 The immediate reaction is no doubt that a large partnership is one that is not small (or medium) in size. The 'Big Four' accountancy firms and the 'magic circle' law firms are clearly large. It is interesting to note that there are only around 200 firms with 100 or more partners; indeed only 3-400 with over 50 partners.[1]

3.2 In most respects, partnerships are transparent vehicles for tax purposes, however large they are. That is certainly the case for capital gains tax, though not VAT. Whilst partnerships are mostly transparent for income tax, that may not be wholly true in an international context – something that is likely to affect large firms far more than small ones. Limited partnerships and limited liability partnerships are regarded as transparent in the UK, but internationally this can vary.[2] Although the partnership has certain reporting obligations, it has no part in the self assessment and payment of the tax liabilities.

Areas of complexity

3.3 Most large firms are constituted as limited liability partnerships (LLPs); though this is a vehicle used by partnerships of all sizes, including two-partner businesses. Many large partnerships have corporate partners among their members. The reasons include:

- profit retention to facilitate working capital;
- tax saving – in that profits are taxed at corporate rather than income tax rates; or
- business reasons – farming partnerships may involve a corporate member to hold land for continuity reasons or as the landlord's representative to allow the landlord to dissolve a lessee partnership to recover their land.

3.4 Whatever the motive for this, complexity is inevitable. It will introduce the need for two tax computations, one prepared in accordance with income tax principles and one for corporation tax – and if there are international partners, this can be doubled to four. It follows that corporation tax self assessment returns are required alongside the income tax returns, computations of worldwide profits for UK residents and UK only profits for non-UK residents.[3]

3.5 Other oddities may be encountered where the partnership contains a company as well as individuals. One commonly occurring is the annual investment allowance (AIA) on plant and machinery expenditure. The capital allowance legislation (s38A Capital Allowances Act 2001) defines the persons qualifying for AIA as including "a partnership **of which all the members are individuals**". Thus the partnership with a corporate member – something that is quite common in farming arrangements – is unable to make use of the AIA.

[1] HMRC statistics: see Annex A.

[2] HMRC guidance at INTM 180010 is useful in this area.

[3] There is of course a current HMRC consultation, being taken forward following the Autumn Statement, in this area.

3.6 The reason for excluding mixed member partnerships from receiving the AIA is because of concern that complex rules would be required to prevent double claims of AIA. (Effectively once through the partnership and the other for the corporate member.)[4] A number of advisers seem unaware that this is the case. Invalid claims in this respect are regularly encountered by HMRC when enquiries into partnership tax computations are undertaken. Whilst we understand the reasoning behind the exclusion, it does seem that many smaller partnerships who would not be in the realms of double claims lose out and we think that a modest extension would be possible without opening the gates to avoidance.

3.7 A growth area in recent years has been the use of partnerships as investment vehicles, often for property or venture capital. General partnerships, LPs and LLPs are all used, often on a mixed basis to meet commercial needs. This has become a useful part of the offerings of the City of London, attracting significant amounts of foreign investment capital. They can be complex in tax terms, simply because of the international ramifications, coupled with what can sometimes be large numbers of partners.

3.8 This international finance marketplace is of course very competitive. The City has advantages with its wider financial environment and the simplicity of the UK partnership is attractive. However, administrative costs caused by tax complexity are, we understand, a source of competitive disadvantage and thus should be an impetus for simplification. Our attention was drawn to the fact that Luxembourg has recently changed its laws to compete for this business with the UK.

3.9 As this is mainly an income tax issue, we return to it in the income tax chapter below.

How HMRC deals with larger partnerships

3.10 We have touched on the issue of the ways in which HM Revenue & Customs handle the affairs of partnerships and their partners in the previous chapter.

3.11 The Large Business Service (LBS) handles the 19 largest partnerships. A customer relationship manager is responsible for each firm and there is ready access to technical specialists. Uniquely, the processing staff deal with the partnership and its constituent partners though non-UK resident partners are still dealt with separately. The professional advisers are exclusively Big Four accountancy firms (or are the firms themselves). Given the ready access to appropriate staff, problems are generally dealt with in real time. Problems can be very unusual with developing business trends and it is sometimes not clear how legislation or HMRC stated practice may apply. Pragmatic solutions can often be negotiated. It follows that professional advisers are generally satisfied with the service provided.

3.12 The Large Partnerships Unit (LPU) deals with a range of larger partnerships, below the very top ones. Some, but not all, of these partnerships may have access to a customer relationship manager or customer coordinator. The affairs of individual partners are still handled by general self assessment processing teams. There is no immediate connection between the work of the partnership team and SA processing. Whilst the LPU are, by definition, well versed in the taxation of partnerships, the personnel dealing with individual partners are not on the same team, and have no special training and are unfamiliar with particular issues. It follows that, especially with complex LLPs, the lack of a holistic approach means that no-one within HMRC has the whole picture of the partnership and its members' tax affairs. This may even mean that avoidance issues are not spotted at an early stage.

3.13 Simply progressing through this three tier system there is a very variable quality of service provided to partnerships and their members. Whilst expertise is clearly available within HMRC, there

[4] A fuller background to this can be found in the HMRC capital allowances manual at CA23082.

seems to be no easy way in which the general processing teams can access this. The members of LBS and LPU that we have talked to generally say that they cannot recall complex matters being referred from the SA processing teams. If they can, it has only been on a very rare occasion.

3.14 One particular issue that has been drawn to our attention is the treatment of partnerships which contain corporate partners. This is addressed separately below.

3.15 Published guidance is largely geared to small partnerships (or, rather, those with simple affairs). Those advisers dealing with the larger partnerships thought that this was unhelpful. It is obvious that LBS are prepared to deal with unusual and complex situations on an ad hoc basis. This could establish practices, and perhaps concessions, that are not widely known. So similar questions can be posed to different individuals and be met with different answers. There is clearly a need for greater clarity and consistency.

Corporate partners

3.16 As noted above, there is an increasing number of partnerships which encompass a company as a partner. Some of these are historic and for genuine business reasons. Scottish advisers indicated that it had been a preferred medium of landholding in agricultural estates for a long time.

3.17 More recently there has been a fashion for corporate partners. This has been encouraged by the divergence of income tax and corporation tax rates. It provides access to specific tax reliefs that are only available to companies, for example, research and development relief. It might also provide a lower effective rate of tax and helps profit retention.

3.18 This gives rise to compliance difficulties for the partnership and its advisers as well as HM Revenue & Customs:

- individual partners still pay income tax on their shares of the profit. Company partners pay corporation tax on their shares. This requires two different computations of the profit according to the differing rules;
- the partnership self assessment return is geared to income tax. Where there is a corporate partner, multiple schedules are inevitable;
- the corresponding position to this is that the corporation tax self assessment (CTSA) return does not recognise partnership income meaning that extensive additional information may be required; and
- there are two separate processes for assessment and payment of the tax from different parts of the same business entity.

3.19 HMRC processing and compliance teams are not set up to deal with the complexities of such an arrangement. Fundamentally, tax is due from the partners, so are handled by income tax teams. Aside from those teams which handle large business, income tax teams do not typically have up to date expertise in corporate tax. Similarly, the company partners are handled in isolation by corporate tax teams. This causes especial problems where an enquiry becomes necessary. Should it be handled by a specialist in partnerships or corporate tax? There seems to be no consistent practice.

3.20 A specific example came from an adviser who said that research and development relief had been denied to a corporate partner on the basis that they were in a partnership. Such relief is due in accordance with the legislation and is confirmed by HMRC's own guidance.[5]

[5] See HMRC's Corporate Intangibles and Research and Development Manual, CIRD 81220.

3.21 This arrangement is not satisfactory either from the point of view of the partnership or HMRC. A more joined-up approach so that the whole arrangement is handled by an income tax team or a corporation tax team has to be preferred, and technical issues are directed to appropriate people, essentially a specialist partnerships unit.

3.22 It should also be noted that, where a business structure includes both partnerships and companies, the partnership does not form part of any group so that it cannot be a conduit for group relief. It is certainly logical and inevitable that the partnership(s) cannot be members of a group; but it is at least arguable, given the way group (and consortia) reliefs have been developed that the group reliefs should be 'traceable' through a partnership. We are unsure how significant an issue this is so do not regard it as a priority issue for simplification.

Residence issues

3.23 The very largest partnerships are multinational businesses. As noted already, this can include investment businesses as well as firms of accountants and lawyers. Such firms will typically have partners resident in a number of countries outside the UK.

3.24 It is not just UK-based partnerships that have partners resident overseas. Many US law firms, for example, have UK-resident partners.

3.25 Many of the firms below that 'top tier', including many relatively modest in size, will have international business activities, though are less likely to actually have some partners resident outside the UK.

3.26 These international links add significant complexities. Firms have to deal with the distant boundaries of the UK legislation but also domestic legislation in other countries as well as double taxation agreements. The issue can be that the partnership is not recognised, or is treated in a different way, in overseas territories. That creates anomalies.

3.27 First and relatively simply, we've heard from external stakeholders that obtaining unique taxpayer references (UTRs) for partners who are not resident in the UK can be difficult. This is especially the case for nominee partners in investment businesses who are outside the UK. Partners in such businesses can also be given multiple UTRs (see paragraph 5.6). The administrative burden this causes must not be ignored. Then there is the additional complexity of profit computations. We have already noted that two computations are required when a partnership has both individual and corporate partners, according to income tax rules and corporation tax rules. The number of computations can be doubled where all or some of the partners are non-UK resident and thus only liable to UK tax on UK source profits. So the corporate/non-corporate divide also becomes resident/non-resident as well. Partial residence may reflect the fact that some partners are resident in a foreign territory whilst others are resident in the UK. To a degree this additional complexity is inevitable with international links but there must be scope to streamline matters.

3.28 The partnership return cannot cope with such complexity of profit computations. It assumes there will be only one. The only way of dealing with this is by attaching extensive additional information to the return. Here again, the self assessment system is not geared to such extensive additional information which may become "lost" in processing. This seems to be a prime candidate for digitisation as most of the businesses involved in such activities will have sophisticated internal systems that can be drawn on.

3.29 At the same time it will become necessary to consider the taxation treatment of the partnership in the other territory(ies). For a true multinational this may encompass many other countries. Those countries may have different views on the taxation treatment of a partnership for the purposes of their own domestic legislation. Some countries will treat a partnership as

opaque and therefore taxable as an entity in its own right. Others will treat a partnership as transparent and the tax treatment follows the partners.[6]

3.30 It will usually follow that a partnership, or its partners, may be taxable in more than one country according to the respective domestic legislation. This is an impost it will not wish to bear. One must turn to the relevant double taxation treaty to resolve the situation. This alone is not easy because of the differing attitudes to partnerships in various countries and consequently different treaty provisions.

3.31 This can become inordinately complicated. International partners coming to the UK may inadvertently create a permanent establishment of their 'home' business in the UK. This may amount to the UK liability being far greater than the profit share of the individual. In reverse, UK partners may find themselves paying tax in more than one system.

Box 3.A: An example of the kind of residence issues partnerships face

We were quoted the example of a UK partnership with some Italian resident partners. Full tax was paid in the UK on UK profits. In Italy, the share of income from the partnership was regarded as dividend income (i.e. the partnership was not transparent) with no credit for UK tax paid.

Note that for partnerships with over 20 partners, there is no assistance from corporate double tax relief as each partner will own less that the 5 per cent interest that is usually a trigger for underlying relief in treaties.

3.32 A fundamental requisite of treaty relief is to establish the tax residence of the partnership and/or partners. HMRC generally will not certify that a partnership is tax resident in the UK. This is because the entity is itself not taxable in the UK, even if it may be in other territories. It is the partners' residence that has to be ascertained, though HMRC will deal with the certification at the level of the partnership. Given the comments we have heard, this procedure needs to be better known and available, easing the process for a partnership with several hundred members.

Box 3.B: A further residence issue faced by a partnership

A UK firm with partners resident in Portugal found that Portugal wanted confirmation that the (partnership) entity is resident in the UK. The usual practice is that the foreign country's residence certificate should be stamped by the UK authority.

However, HMRC would not stamp the document as requested because in their eyes UK tax law defines a partnership (including an LLP) as transparent for tax purposes, so cannot be UK resident. HMRC did stamp the covering letter, as that made it clear that the partnership was not resident but the partners were. Predictably that, though, was unacceptable to Portugal. It took the firm nine months to get to a solution.

HMRC's stance is correct in the strict letter of the law but the firm concerned felt that they were left trying to sort out a problem with no help from the UK tax authority. We are pleased to hear that HMRC has engaged with the Portuguese tax authority to resolve the matter more generally.

[6] The OECD has carried out work on this whole area, which we readily acknowledge. But the examples cited to us by a number of large firms suggest that more needs to be done to smooth business arrangements for partnerships internationally.

3.33 The consequence of the inability to certify residence of a partnership can be additional withholding taxes as treaty relief cannot be accessed. That in turn can result in overall irrecoverable tax. This should only happen in exceptional circumstances and we have been told by HMRC that they are willing to take up problems with overseas authorities to resolve matters for the future. Again, we suspect this is not well known by affected partnerships.

3.34 Even if the correct residence position can be established, that is not the end of double taxation relief problems. Foreign taxes may be applied to the partnership as an entity but the UK seeks to tax the constituent partners. How should relief be given? We understand that, in some situations, pragmatic solutions have been struck but we have been told that in others the business has been forced to accept double taxation. HMRC do point to the 'Mutual Agreement Procedure' as another route to a solution.

Complex business structures

3.35 The complex structures operated by some businesses are responses to the modern business environment. They develop over time to meet current challenges and are constantly evolving. Further there is global mobility of partners. Today's London partner may be tomorrow's New York partner or vice versa. The UK tax system, in common with many others, finds it difficult to cope with this sort of situation.

3.36 As well as the trading partnership with active professional partners, partnerships are increasingly used for investment and coordinating structures. A typical venture capital structure might include the following:

- the venture capital investors use an LLP to carry out the management function;
- derive a return via a LP;
- use another LP to channel their investments, and those of others, into the trading companies; and
- may also have a general partnership involved.

3.37 Another example of the complex business structures now being used is the nested partnership. This is (usually) a limited liability partnership which is a member of another limited liability partnership. In theory it is not possible for a general partnership to be a member of another partnership though we have been advised that some examples do exist. The situation can be repeated in multiple layers.

3.38 The UK legislation was never designed to cope with such arrangements. Treatment of nested partnerships is not currently covered in HMRC guidance or in leading textbooks on partnerships and perhaps because of this there could be inconsistency in treatment. We think that resources need to be devoted to developing the tax law and practice for such vehicles – and generally in ensuring that the tax law keeps pace with developments in business practices. As we have noted in other contexts, we suspect that these sometimes novel vehicles are viewed with a certain amount of suspicion by HMRC whereas they seem to us to be there for genuine business reasons.

3.39 Although we refer to 'developing the tax law' in the previous paragraph, we do wonder if the best route would be a working group set up jointly by HMRC and relevant industry participants to discuss developments in structures. The aim would be to develop practical answers to tax issues, probably by agreed practice rather than trying to develop formal tax legislation.[7]

[7] We note in passing the 'Wilkinson issue' – discussed at paragraph 6.30 in the context of SP D12 – but do not believe it would present a problem in developing solutions in this area.

Should LLPs pay corporation tax?

3.40 We have to note an extreme and radical solution to some of the complexity issues faced by the largest partnerships. The majority of these are not general partnerships. Rather, they are limited liability partnerships. As such their constitution is as a body corporate, though from their inception, for tax purposes, they have of course been treated like 'ordinary' partnerships.

3.41 We have met views both inside and outside HMRC that they should be treated like companies. In other words, LLPs could pay corporation tax and be allowed to retain profits for working capital.

3.42 LLPs paying corporation tax removes some of the complexities which we have set out. Some of the more important effects are:

- payment of the lower rates of corporation tax rather than the higher marginal rates of income tax eases the burden for those businesses which wish to retain profits for investment;
- further tax would become due on withdrawal of profits (akin to salary and dividends for the director/shareholder of a company). This can be managed more easily; and
- it provides access to the corporate tax reliefs which are a part of the rationale for introducing corporate partners so a separate corporate partner computation would no longer have to be done. As well as the lower rates of tax, these include the intangibles regime and research and development relief.

3.43 It should also remove some of the difficulties of residence. If the LLP can be certified as the taxable entity double taxation relief problems may be alleviated. This is, of course, dependent on domestic legislation in other countries as well as the terms of particular treaties.

3.44 Distributions of individual partners' profit shares would be subject to tax. Such tax could still be the current income tax (and Class 4 NICs) charges on partners' profits, with the corporation tax paid being treated as a payment on account.[8] Of course, it would also be possible to regard such drawings as earnings subject to Class 1 NICs (or even as dividends with no NICs), though this would be less logical.

3.45 No doubt if this change was explored, consideration would be needed for anti-avoidance legislation, perhaps paralleling that on disguised employment. At the same time, it is possible that this 'corporate' route could eliminate some of the avoidance issues that are of concern to HMRC. Many of these depend on the availability of (income tax) loss relief. If such losses are ring-fenced in what is treated as a corporate entity, the advantage is gone, though that restriction on loss offsets would itself be a significant policy shift and present a serious practical problem.

3.46 As an alternative, a number of people have suggested that the LLP itself should be chargeable to income tax at the basic rate. As profits are distributed, they should be taxed on the partners as income and charged to income tax at full marginal rates, with credit for the income tax already paid. Presumably Class 4 NICs would be levied at the same time. The advantage to this process would be that profits retained in the business for reinvestment would have suffered tax at basic rate only, putting the LLP on a more equal footing as compared to a company.

3.47 Either route would clearly be a significant policy change and as such is really beyond the remit of the OTS. It would also be a reversal of the decision taken when the LLP Act was being

[8] Note that with the impending reduction in corporate tax rates to 20 per cent, this would equate to the LLP paying basic rate income tax, with higher/additional rates being due from the individual partners.

developed on how LLPs should be taxed. They do offer simplification possibilities, but inevitably attracted mixed opinions. We would be remiss if we did not at least mention these possibilities, although we are not recommending this as a further area for review.

Simplification

3.48 There is less scope for simplification for larger partnerships than there is for smaller ones: the service HMRC provides to larger partnerships effectively already provides substantial simplification. However, there are a few issues which HMRC could focus on, which mostly surround international issues.

Short term fixes

3.49 HMRC need to be geared to provide UTRs to foreign resident partners quickly (subject to a more general simplification that may eliminate the need for them in many cases).

3.50 Many non-domiciled individuals invest money in UK investment partnerships. The reliefs around the remittance basis are available to partners in the same way as to other individuals, but under general partnership tax principles do not apply to the partnership as a whole. Private equity firms have made the point to us that it would be helpful to have a procedure to get some form of general or 'block' relief for a group of non-domiciled partners.

Longer term areas for the OTS to explore

3.51 The UK authorities need to recognise the importance of the partnerships business sector and put effort into making sure double taxation agreements deal with partnerships and promote similar efforts at OECD & EU level. Obviously HMRC cannot unilaterally solve these issues or control double taxation agreements.

3.52 However, what we think is possible is that HMRC should initiate reviews with other countries of the way partnerships are treated. More recently we have heard from external stakeholders that HMRC has taken useful steps in the right direction to include partnerships in double taxation agreements.

3.53 We also think there is a need to ensure that developments in business structures are dealt with properly by the tax system. The best route may be a permanent HMRC/HMT/business liaison body to keep developments under review and help develop solutions. Such engagement should also help remove some of the suspicions that are prevalent – on all sides – about new structures and tax changes.

3.54 We would like to develop a detailed list of international tax and administrative issues faced by large partnerships with a view to identifying ones that HMRC could assist with and ones that need to be pursued bilaterally or via the OECD or EU.

4 Income tax

4.1 In many ways, the existence of a partnership is an irrelevance other than as a basis for establishing taxable income. The partnership is effectively ignored and the partners' shares of profits are charged to income tax as with any other source of income, be it employment, self-employment, property or savings and investments.

4.2 It is also true that many of the tax difficulties affecting sole traders are replicated in partnerships. Below we have looked at three issues (basis periods, overlap relief, and expenses) which are also problems faced by smaller businesses, but which contain an additional area of complexity created by additional partnership legislation and administration.

Basis periods and overlap relief

4.3 Overlap relief is a complexity for all businesses charged to income tax, not just partnerships. What makes the issue more complex for partnerships is the way partners join and leave; international links then add to the partners' problems. It is a consequence of the general rule that income tax for a tax year is based on the business accounts drawn up for a year ending in that tax year.[1]

4.4 A business can draw up accounts to any date it wants to. If it draws up accounts to 5 April (or 31 March) every year then the position is very straightforward. For example, income tax for the tax year 2013-14 is based on the accounts profit for the year ended 5 April 2014.

4.5 If it draws up accounts to any other date, it becomes complicated. For example, if the business draws up accounts to 31 December every year, income tax for 2013-14 is based on the accounts profit for the year to 31 December 2013.

4.6 The complexity arises because of the way businesses are taxed when they start trading. The income tax for the first tax year is based on the profits between the date the business starts and the end of the tax year (see example below). The income tax for the second tax year is usually based on the profits for the year ending on the accounting date in that tax year. So the profits for the first part of the accounting period can be taxed twice. That is why overlap relief is needed. The profits taxed twice are carried forward and given as relief when the business stops trading. As far as individual partners are concerned, these adjustments are required at the point of joining or leaving a partnership, though the partnership business may continue throughout.

[1] ITTOIA 2005, s 198

Box 4.A: An example of overlap relief

Partnership A's accounting date is 30 June. John was invited to join the partnership on 1 July 2005. His shares of profit have been as follows:

30/6/06 £50,000

30/6/07 £60,000

30/6/08 £70,000

30/6/09 £80,000

30/6/10 £90,000

30/6/11 £100,000

30/6/12 £120,000

On 31 December 2012 he resigned from the partnership. His final profit share was £60,000. The increasing amounts of profit earned are due to inflation and increasing seniority in the partnership. The total amount earned by John whilst he was a member of the partnership was £630,000.

The income tax assessments are as follows:

2005/06 £37,500 (the amount actually earned in the tax year = the period from 1/7/05 – 5/4/06 = 9/12 x £50,000)

2006/07 £50,000 (the profits earned in the accounting year ending in the tax year. Profits for the period 1/7/05 – 5/4/06 have been assessed twice creating overlap of £37,500)

2007/08 £60,000

2008/09 £70,000

2009/10 £80,000

2010/11 £90,000

2011/12 £100,000

2012/13 £180,000 (Profits from end of previous basis period = 30/6/12 to date of leaving partnership = £120,000 + £60,000)

Total profits assessed throughout period in partnership £667,500. John may claim overlap relief in respect of the amount charged twice when he joined the partnership – £37,500. This reduces the 2012-13 assessment to £142,500. The total actually assessed over the life of John's partnership is £630,000, equal to the amount actually earned. However, John suffers high tax bills at both the beginning and the end. Firstly, due to the double taxation of his early profits. Secondly, because the value of the overlap relief at the end is relatively small.

4.7 Overlap relief is designed to ensure that the total profit taxed over the lifetime of the business is the same as the total profit made by the business. However, there are four main drawbacks to this system of taxing business profits:

- First, if the business carries on trading the real value of the overlap relief is eroded by inflation. Over 20 or 30 years it can become half or less than its original value;

- There is a need to keep a record of the overlap relief to be able to use it. This should be recorded on personal tax returns though these are often deficient in this respect. HMRC does not maintain a record, so sometimes there is no way of knowing how much relief to give when a business ends;
- In the example above, the tax for the first tax year for John will have been based on the first nine months of trading. The business would not have known how much profit they made until they drew up accounts for the first year, after 30 June 2006. As the deadline for filing the 2005-06 return was 31 January 2007 there is probably enough time to draw up the accounts, though John may still find a need to estimate his profit as the business will be working towards a filing date of 31 January 2008 for the profits for the year to 30 June 2006;
- Note that if the firm prepared their accounts to (say) 31 December, John may find more of a need to base his first year's tax on estimated profits. That would need to be corrected when the first year's accounts are produced; and
- Finally, there can be problems with double taxation relief in the final year of trading, when the overlap relief can reduce the taxable profit to a level that will leave some double taxation relief unused.[2]

Simplifying overlap relief

4.8 It must be acknowledged that many practitioners do not see a particular problem with overlap relief: it is sufficiently well established to be just 'part of the fabric' of the system. However, it is undoubtedly a source of complexity and confusion: to the ordinary taxpayer, the complexities of the opening year rules appear to be a way of extracting additional tax. It does seem worth seeking simplifications, though this is an issue for sole traders as much as partnerships.

4.9 There are a number of possible solutions to the problems created by overlap relief:

- make businesses use 5 April (or 31 March) as their accounting date. We raised this idea in meetings but, predictably, it didn't find favour with anyone. Businesses want to be free to choose their accounting date for commercial reasons, and not be forced into a straightjacket by the tax system;[3]
- don't tax the business in the first tax year covering a part of the first year of trading;
- for each tax year, tax the profits that fall into that tax year;
- give overlap relief after a set period e.g. 5 years; or
- give overlap relief as tax credit rather than as a deduction from profits.

4.10 We think the last of these possibilities has the most potential and would seem fairer to many taxpayers. There would be an element of 'luck of the draw' depending on how tax rates changed for the duration of the relief.

Partners' personal business expenses

4.11 Many partners will personally incur genuine business expenses which relate to the partnership of which they are members. Most commonly these will relate to personally owned

[2] The mirror-image situation can also cause problems – ie the UK-resident partner of an overseas partnership who is effectively taxed twice in early years may not get full relief for tax paid in the UK against the 'home' tax liability.

[3] There were some counter-suggestions that the tax year end should change from 5 April to 31 December – a point the OTS made in its small business report.

cars outside the partnership. There will be differences in mileage as well as the choice of car. It is particularly prevalent in doctors' practices and the doctors will wish to make personal expense claims. Depending on the nature of the business there may be a range of other expenses, principally use of home.

4.12 A substantial majority of the advisers that we have consulted (and some partnerships themselves) have said that it would be enormously beneficial to have the facility for partners to make personal expense claims for such business-related expenses. The need to incorporate such expenses in the partnership tax computation actually creates more complexity with partnerships, mainly from an administrative point of view: the need to wait until the last partner has sent their expenses into the person compiling the partnership return often delays matters significantly[4]. Not only does the scale of the problem increase with the size of the firm but it becomes more likely that different partners have different advisers making liaison more difficult. Oddly, it is the smaller partnerships that are generally happy with the present arrangement. This is usually because the same adviser will deal with the partnership and all the partners.

4.13 HMRC do not permit individual expense claims, maintaining that it is not possible under the current law. Their view is stated in the Business Income Manual.[5] Despite HMRC's belief and guidance, it would seem that some partners do make personal expense claims and, largely, this goes undetected, or is at least allowed by their tax inspectors. This is a side effect of HMRC's administration processes. For most partnerships, there is no link between the processing of the partnership return and the individual partner returns. In the absence of an enquiry, there is no cross checking of the profit figures. Therefore a discrepancy, which may be due to expenses claimed, between the profit declared by the partner and the partnership return usually goes unnoticed. It is impossible to quantify how prevalent this may be.

4.14 Some of the very largest partnerships sidestep the issue. Many simply prohibit partners from claiming personal expenses. A number have negotiated flat rate allowances for 'use of home' expenses (often a significant issue for partners) which are automatically included in the partnership computation on a per capita basis. In the meetings and discussions that the OTS held, there was a very large range in the size of the figures, with the largest encountered being £1,200 and the smallest £500. Some firms, though, were unable to agree a figure with HMRC[6] and so had an effective figure of nil. Those who had no allowance agreed for home expenses generally banned the partners from making expense claims but this is essentially for practical reasons.

4.15 HMRC guidance goes on to say 'This does not mean that expenditure incurred by a partner can only be relieved if it is included in the partnership accounts. You may accept adjustments for such expenditure in the tax computations included in the partnership return providing the adjustments are made before apportionment of the net profit between the partners. But once the adjustments have been made the expenditure is treated, for all practical purposes, as if it had been included in the partnership's accounts.'[7]

4.16 Apart from practical difficulties, the quoted words "… providing the adjustments are made before apportionment of the net profit …" cause a problem in themselves.

[4] All acknowledge that individual partners should get their expenses in promptly of course, but we are dealing with busy doctors, architects etc to whom paperwork, especially about small sums linked to tax matters, comes a distant second to their 'day job'.

[5] BIM 82075

[6] We would note in passing that this is a good illustration of a general issue that was raised with us in a number of meetings: the way that the lack of formal partnership tax rules in a number of areas means varying tax treatments for different firms. That in one sense is unfair; it is certainly inefficient. It is the basis of the calls we have heard for HMRC practices to be formalised and published.

[7] BIM 72075

Box 4.B: Partners' expenses

The partnership profit assessable in 2013-14 is £200,000. The partners incur motor expenses, agreed to be allowable of A: £10,000, B: £2,000, C: £1,000. The agreed profit sharing ratio is A:B:C 50:30:20. For simplicity National Insurance contributions have been disregarded.

Version(i) follows HMRC guidance. It assumes that the total of all partners' expenses must be deducted from the partnership profit before allocation to the partners.

	Total	A	B	C
Profit (£)	200,000			
Expenses	(13,000)			
Net allocated	187,000	93,500	56,100	37,400
Tax payable	(45,076)	(27,222)	(12,262)	(5,592)
Net income	141,924	66,278	43,838	31,808

Version (ii) reflects what some would regard as the true position. It assumes that the partners may make personal expense claims after the allocation of profit to the partners so that each partner in effect bears his own expenses from his own profit share.

	Total	A	B	C
Profit (£)	200,000	100,000	60,000	40,000
Expenses	(13,000)	(10,000)	(2,000)	(1,000)
Net taxable	187,000	90,000	58,000	39,000
Tax payable	(44,756)	(25,822)	(13,022)	(5,912)
Net income	142,244	64,178	44,978	33,088

Whilst there is no significant change in the total tax liability, the balance between the partners in terms of who pays how much tax, and therefore the final disposable income is very different. In effect the more junior partner is subsidising the senior partner.

4.17 The figures for tax payable in the example above assume the income tax rates and allowances which are applicable for the tax year 2013-14. For simplicity, National Insurance Contributions have been ignored.

4.18 It has been suggested that the numerical differences between the calculations in versions (i) and (ii) above could be dealt with by allocating prior profit shares equal to the amount of each partner's expenses. The balance would be divided according to the agreed profit sharing ratios. However, we feel that this is unlikely to work for three reasons:

- there remains the problem for the partnership of trying to establish what each partner's expenses might be. This is precisely the issue which personal expense claims might overcome;
- it does not follow HMRC's guidance that adjustments (to the gross profit) should be made before the allocation between partners; and

- with larger partnerships there would be an additional practicality of incorporating the issue into the partnership deed. This too has to run counter to the intended simplification.

4.19 Prior to the advent of self assessment for income tax, the Inland Revenue (as it then was) would issue a single composite assessment to a partnership. The partnership had joint and several liability for payment of the tax due. Despite this, it was common practice for individual partners to make their own personal claims for expenses incurred in undertaking the partnership business.

4.20 Self assessment did not change the manner in which business profits are to be computed. Rather it changed the manner in which the liability is assessed and the tax collected. From then on, each individual partner became personally liable to self assess the liability and pay the tax on his personal share of the partnership profits.

4.21 HMRC argue that personal expense claims are no longer permitted because the law was changed with the advent of self assessment. S849 Income Tax (Trading and Other Income) Act 2005 currently requires that the profits or losses of the [partnership] trade are calculated as if the firm were an individual. Previously, s111 Income and Corporation Taxes Act 1988 required that income tax in respect [of a partnership] should be computed and stated jointly and in one sum (and a joint assessment shall be made in the partnership name). There does not seem to have been a material change.

4.22 If the recent decision in Vaines v HMRC[8] stands, this would seem to be evidence that HMRC's present view is incorrect. However, this is currently only a First Tier Tribunal case and HMRC has been granted leave to appeal to the Upper Tribunal. Their decision will in due course provide guidance on the legislation and HMRC have made no changes to their procedures. We do have to note the case as it has considerable interest among partnerships and it is an example of the difficulties faced by partners with the current expenses system.

Other income tax simplifications

4.23 Given that investment income, usually bank deposit account interest, is earned by the partnership and included in their accounts, confusion then arises on the tax return as the requirement is to report the fiscal year income, not as in the accounts. At the same time, the (adjusted) trading profit of the accounts forms the basis of the assessment on the trading profit element.

4.24 Allowing the reporting of interest by reference to the accounting period would simplify matters for many partnerships, and reduce the number of errors (and the costs related thereto) that HMRC currently have to deal with. This would be consistent with corporate reporting and seem more logical to the partners (as it is currently a cause of confusion and misunderstanding in most small partnerships). Similar considerations arise in respect of rental income and partnership charges.

4.25 There is an issue with partnerships that contain a corporate member, as their partnership share is subject to corporation tax. This has been covered in the previous chapter on large partnerships.

4.26 The rules about intangibles could be usefully aligned with the rules applicable to companies. Partnerships which wish to access this regime have the option of holding intangibles in a subsidiary company (though this may cause other issues, as discussed in our inheritance tax section). Corporate partners can also access relief.

[8] [2013] UKFTT 576

National insurance contributions

4.27 National insurance contributions (NICs) are not strictly a tax, although they are collected by HMRC. They nonetheless add to the complexities generated by income tax. The taxation of partnerships mirrors that of the self-employed. It is necessary for an individual partner to register for NICs at the same time as he registers for income tax. There is then a requirement for the class 2 contributions to be paid, usually by direct debit. Class 2 NICs bring entitlement to contributory benefits. HMRC have of course been consulting (in a document issued on 18 July 2013) on proposals for simplifying NICs processes for the self-employed (including partners), following earlier OTS recommendations.

4.28 This adds particular additional burdens for investment partnerships, as class 2 NICs are a real administrative problem. For one investment firm, 99 per cent of investors are also employees in other businesses, so are exempt from paying class 2 NICs. Some private equity funds have retail investors, which raises the question as to how they pick up the class 2 NICs. Generally stakeholders feel that it's practically unworkable to collect class 2 in these cases; before partners had to be in a trading firm to pay class 2, now the firm just has to be in business. One tax adviser estimated that the cost of collecting and enforcing class 2 NICs for property investment partnerships may be larger than the revenue actually brought in.

4.29 Additionally, the partnership profit share allocated to the individual partner is subject to class 4 NICs. If a partner is also subject to tax on earnings, he will be subject to class 1 NICs, and it may be necessary to apply to have a deferment of class 2 and or class 4 contributions.[9] Some partnerships were generally unaware of this process or felt that it was overly cumbersome; either way, this can result in incorrectly paid NICs at the end of the year, which had to then be reconciled by HMRC.

Further areas for the OTS to explore

Basis periods and overlap relief

4.30 We have set out possible solutions to the complexities caused by overlap relief above, but are not making formal proposals at this stage, though the most promising route would seem to be a change to giving relief as a tax amount. We would like to look into this area further in the second part of our review, with a particular focus on small businesses, but also with the difficulties faced in international situations in mind.

4.31 Additionally, we would like to look into the possibility of simplifying basis periods for non-trading income of partnerships, e.g. by including the possibility of being able to sweep small amounts of interest or property income into trading income.

Partners' expenses

4.32 We believe that allowing partners to claim expenses on their individual tax returns is a very helpful administrative improvement that could be made to the taxation of some partnerships. There has been very strong support for the idea amongst those groups that we have consulted. If legislative change is needed then changes should be made.

4.33 This would be beneficial in many ways:

- more efficient individual partners would be able to finalise their personal returns earlier;

[9] To apply for class 2 and class 4 deferment, form CA72B needs to be filled out.

- where multiple agents act for different partners and the partnership, there is no longer need for liaison between them;
- it should be possible to finalise the partnership return at an earlier stage, resulting in fewer late returns; and
- it reflects the reality of what is happening: some individual partners incurring and now getting relief for their own expenses.

4.34 In theory this should be a cost neutral change as it would simply move tax relief. However, we suspect there would be a small exchequer cost simply because some partners who are currently unable to make claims for genuine expenses would be able to do so. It seems a matter of fairness that they should be so allowed.

4.35 To give effect to this simplification, we do not envisage that huge changes would be necessary to the partnership pages (SA104F) of the self assessment tax return. These already recognise adjustments for issues such as basis period and profit averaging. It would seem to need only a different reason for the adjustment. There already exists in the notes to SA104F a working sheet for calculating adjustments. This would need only minor extension.

4.36 There are possible downsides, including:

- enquiry periods: because expense claims become a personal issue, enquiry windows would no longer be co-terminous with the partnership itself. However, this could be managed by having the partnership enquiry window override the individual window if it is longer for enquiries into the partnership figures. (The individual's enquiry window would remain in place for everything else on the return.)
- HMRC administration: HMRC would undoubtedly be faced with more expenses claims but that should not of itself be a significant matter, given that the partners would be making returns already. Developing standard 'home costs allowances' would streamline procedures to advantages on both sides (the flat rate allowances introduced in Finance Act 2013 for the smallest businesses could be a basis but the levels need to be realistic).
- as previously mentioned, this would create a small cost to the exchequer for partners claiming expenses they were previously unable to.

4.37 HMRC have suggested that a change to allowing partners to make expense claims would actually be a complication of the existing system. This is because they suggest that:

- the partnership would need to adjust its accounting profit to exclude any expenses so claimed;
- the individual partner would need the partnership to 'top up' their tax relief for their expenses to reimburse the partner for the full amount of the expense;
- such a top up would require careful calculation of the income tax and NICs position of the various partners; and
- all this is based on their view that the expenses in question are expenses of the business carried on in partnership and should be taken into account in calculating the profit of the partnership.

4.38 We note HMRC's view but feel that, based on the comments we have received from partnerships and advisers, the result would indeed be a simplification. The individual partner would claim the expenses in question against their own share of the profits and that would be that. There would be no adjustment through the firm.

4.39 As with other ideas noted, there is scope for this change to be facilitated by digitisation. Indeed, it would probably be a necessary change: we envisage the individual partner keeping their own expenses records and using a digital process to feed them into their own tax calculations.

5 HMRC administration

Registering a partnership

5.1 Several people that we have spoken to feel that the process for registering a partnership can be cumbersome. The current method for notifying HMRC of a partnership is to fill out an SA400 form (registering a partnership for self-assessment) for the partnership and an SA401/402 form (registering a partner for self-assessment and class 2 NICs/if they're not an individual) for each partner. Feedback suggests that this process involves too many forms and can become confusing. But if an SA400 is sent to HMRC without the accompanying forms, HMRC's computing systems will set up the partnership with only one partner.

5.2 The details on the SA400 and SA401 may differ slightly e.g. in partnership name if a partner fills out their own SA401 without referring to the information on the SA400. If this happens then HMRC's computing systems will set up a new partnership with only one partner. This can result in more than one record being set up for the same partnership, resulting in different partners linked to different records, or incorrect penalties leading to appeals.

5.3 One member of HMRC's operational staff suggested to us that these forms could be slightly improved through cutting down the number of questions on them: e.g. the SA400 asks for the accounting date of the partnership but there is nothing HMRC do with this information.

5.4 Tax advisers noted that it was particularly difficult to get forms 64-8 (agent authorisation forms) in place with partnerships, and that the registration does not always work.

5.5 More generally, we have heard of a number of problems with the unique taxpayer reference (UTR) encountered by partnerships. Occasionally when a partnership was registered, not all the UTRs for the partners were received, or a UTR for the partnership was not received. The UTR system for LLPs was pointed out as being particularly problematic (although this is a problem with Companies House systems rather than HMRC), and presented many more faults when compared to a similar system used for limited companies. UTRs were also a problem for the largest partnerships and investment funds. As noted in previous chapters, we heard of difficulties in obtaining UTRs for non-resident partners hoping to invest in a UK fund. This often delayed the submission of the partnership return, which cannot be submitted without all the partners' UTRs in place.

5.6 Usually, each partner receives a UTR for each partnership they are involved with. Because of the way investment funds are structured this has led to situations where an individual could have 40 to 50 UTRs, which can be very confusing for both them and HMRC. It also adds to the costs of administering such businesses, often in situations where there is no UK tax liability on the non-resident investor.

5.7 It was felt that there were often times when non-UK resident partners should not require UTRs. More generally it was felt that non-resident/non-domiciled individuals shouldn't need them when they are not liable for UK tax and indeed, shouldn't have to file a return at all. The partnership return – effectively the business return – should suffice with a suitable certificate or declaration about such 'nil income' partners.

The partnership return

5.8 Partnerships have largely the same process to small businesses for filing tax returns. Each member of a partnership is separately required to file an individual return with SA104 pages. The partnership is then required to file a partnership return.

5.9 There were mixed feelings about the partnership return among advisers. Frequently there was a call to abolish the partnership return for the smallest partnerships: a further discussion on this can be found in paragraphs. 2.16-2.29. The short return for partnerships was felt to provide a substantial simplification. However, the short return does not allow partnerships to return gross interest, only interest received net. It has to be a simplification to allow the inclusion of gross interest.

5.10 Currently there is no automatic cross-checking of profit figures between partnership returns and the individual partners' returns, except in certain cases where HMRC carries out risk based checks. This can mean that partners can report completely separate figures from what is documented on the partnership return. We've heard estimates that thousands of partners declare different figures from the partnership return each year. HMRC operational staff have expressed some concerns about this, both with regard to errors and possible tax avoidance, though it is quite likely that many such differences are legitimate (in the partners' eyes), being due to expenses.

5.11 Filing the partnership return with a corporate partner was problematic, though this only affects a small number of partnerships (only 5 per cent of partnerships). The partnership return did not have a separate section for corporate partners, so the figures for corporate partners had to be put in boxes tailored to income tax and then a separate explanation placed in white space below. The cross-checking process mentioned above cannot cross-check between the records on the partnership return and corporate partners.

5.12 Large partnerships have some confidentiality issues with the partnership return. Many firms would like to simply copy the statement to the partner's advisers, but each page 7 of the return has room for two partners' details; partners would not wish their details to be shared with advisers outside the firm. The general solution for this is to fold one half of the page in two to hide it from the other partners, which can be time consuming if a firm has a very large number of partners. There may be a quick administrative solution to this if it was cheap for HMRC to provide a version of page 7 with space for only one partner. This issue was raised with us particularly by one firm in respect of their clients but at the same time they were keen to praise LBS for being pragmatic in the area. As was previously mentioned at paragraphs. 2.35-2.37, one of the biggest improvements HMRC could provide to the administration of partnership tax is to provide free software for small (two or three person) partnerships. It has been observed by a major software provider that partnership tax is the 'Cinderella' of the online tax project, and HMRC's efforts so far have concentrated on individual self assessment to the detriment of partnerships.

5.13 One minor issue raised by stakeholders was that an LLP could not claim gift aid payments on the partnership return. This follows from gift aid being a relief for individuals, not partnerships. Many firms want to take their decisions collectively and so some firms set up a charity to handle gift aid tax relief for the partners. This seems cumbersome and should not be necessary. Ideally the gift aid rules would be changed to allow the partnership to claim relief as a deduction in their accounts but it may be that HMRC are concerned about avoidance.

Penalties

5.14 Penalties linked to the partnership return were generally thought to be exceedingly harsh. The penalty for a late partnership return is £100 on each partner, rather than just £100 on the

whole partnership. This means that a partner can be penalised through no fault of their own, and the penalties are higher than those on a sole trader with no additional tax at risk.

5.15 We heard reports from HMRC operational staff who deal with smaller partnerships where only one partner would be involved with the tax affairs of the firm. This would mean that the other partners would receive a penalty notice without knowing why. The larger the business, the less likely it is that the wider majority of partners have anything to do with the firm's finances; it then becomes unreasonable that they should be charged a penalty in respect of which they have no control. (Though all acknowledge the theoretical joint responsibility of all partners for all partnership matters.) HMRC figures suggest that for 2011-12 returns 9.6 per cent of partners received a late penalty solely because of the partnership return; this seems unreasonable for a form which has no tax due on it.

5.16 More generally there were some practical problems with penalties for larger partnerships. A penalty notice only contains a UTR, so if a partner was in more than one partnership (and some are in 40 to 50) it would be difficult for them to know which partnership it related to.

5.17 Penalties for large partnerships can be difficult to administer. In practice since the penalty is not charged on the partnership but on each member, the appropriate documentation, including that on human rights, could have to be sent out to several hundred individuals. If the penalty is tax-geared, then the penalty has to be charged to each partner based on their marginal rate of tax. This can become cumbersome to administer very quickly.

5.18 There is then a problem over partners appealing against penalties. Because the penalty is on the partnership return, only the representative partner is able to appeal. If the representative partner does not appeal – perhaps because they know there are no grounds for a 'reasonable excuse' defence, individual partners cannot appeal even if they believe they have a reasonable excuse in their own circumstances. This can cause significant unfairness, as demonstrated in some recent Tribunal cases.[1]

HMRC processing and communications

5.19 There are a number of inconsistencies as a result of the split nature of treatment between partner and partnership. For example, an individual partner is responsible for reporting a gain, but if that gain is amended, it is only at partnership level. Equally, following an enquiry, or recovery of tax claim under Sch 1AB TMA 1970, only the partnership position is amended.

5.20 There are practical problems with very large partnerships with many hundreds or even thousands of members. For example, HMRC may open an enquiry into a partner on a non-partnership issue, and close the enquiry without consulting the office that handles the partnership. There can be poor or no communication between tax offices dealing with partnerships and partners. HMRC can also be inconsistent in who is sent enquiry notices.[2]

5.21 There are difficulties where an agent only represents the partnership rather than one particular partner. Notably, it is not possible for an agent to communicate with HMRC about a partner's tax affairs unless the partner is their client; they may just be the agent of the partnership.

5.22 HMRC do not currently provide a single, consolidated manual of guidance on partnerships. This can make it very difficult for users of the partnership tax system to know what their obligations are. A manual is currently in draft by HMRC, which we commend. When it is published it will no doubt provide considerable simplification, not least through improving consistency.

[1] e.g. Linda Jarvis v HMRC, 2012 UKFTT483, TC02160, or McKendrick v Revenue and Customs, 2012, UKFTT376, TC02060.

[2] In one case cited to the OTS, a partnership asset was disposed of (so all partners made a disposal) but not all the partners received enquiries about it.

5.23 The individual acting on behalf of the partnership's tax affairs is known as the 'nominated partner'. However, there can be confusion around what a nominated partner is. The legislation (and HMRC guidance) implies that the nominated partner is a permanent position.[3] In practice the nominated partner can change year-on-year and simply is the partner who submits the tax return.[4]

5.24 Confusion surrounding the nominated partner can create problems for HMRC operational staff. When returns are submitted online the nominated partner very frequently isn't named (one member of operational staff thought that up to 50 per cent of online returns have this problem), or the name of the partnership is put in its place. This can make HMRC unsure of who they are supposed to contact about the partnership. One external stakeholder felt that HMRC struggled in knowing who to send notices to.

5.25 HMRC software can't deal with the very largest partnerships especially well. The current software for capturing returns can only cope with 999 partners, so additional partners have to be squeezed onto one section. This can cause problems for the compliance teams, as 1000+ partnerships do exist. (Anecdotally, some partnerships used for avoidance may have more than 20,000 partners though this is hardly justification for developing new systems.)

Simplification

Short-term fixes

- HMRC should add a box to include interest on the short return in gross terms rather than just net;
- as mentioned previously in the 'small partnerships' chapter, HMRC should provide a consolidated manual of guidance for partnerships;
- as previously mentioned, HMRC needs to develop free filing software for small partnerships; and
- the CTSA return ought to include a section or box for partnership income.

Further areas for the OTS to explore

- although the OTS is not making any recommendations at this stage, we would like to investigate how the late filing penalties for partnerships on the partnership return could be changed with the aim of making them fairer;
- linked to this, we would plan to extend the work into the appeal rights of individual partners; and
- we think the law on gift aid should be changed to allow partnerships to claim relief, paralleling companies.

[3] Particularly the Taxes Management Act 1970.

[4] HMRC's Enquiry Manual at EM7023.

6 Capital taxes

Capital gains tax

6.1 A common theme of many stakeholders' comments, statistics, published commentaries etc is that no-one understands capital gains tax (CGT) in relation to partnerships. CGT is treated in exactly the same way as income tax. That is, any tax arising on the disposal of a capital asset is charged on the individual partners rather than the partnership itself.

Legislation

6.2 There is very little legislation to be found on how the members of partnerships are meant to be taxed on their capital gains. The fundamental legislation is currently stated in s59 Taxation of Chargeable Gains Act 1992 (TCGA 1992). This is brief almost to the point of confusion. It remains unclear what exactly the phrase in sub (1)(a):

"tax in respect of chargeable gains accruing to them on the disposal of any partnership assets shall...be assessed and charged on them separately"

might mean. For example, it has been suggested to the OTS that this could be interpreted as meaning that the whole of the partnership gains could be charged on each partner.

6.3 S59A TCGA 1992 was introduced in 2001 to apply capital gains tax to the members of limited liability partnerships. In essence, it parallels section 59 though with one important distinction: if the LLP ceases to carry on a trade or business in circumstances other than those specified, then the LLP itself becomes chargeable to tax on any gains arising as if it were a company. The specified circumstances are that the trade or business has only ceased:

- temporarily; or
- as a prelude to winding up.

6.4 In other words, a LLP which has no trade or business is taxed on any gains that are realised as if it were a corporation.

Partnership gains generally

6.5 The vast majority of partnerships are small general partnerships. They tend to own few, if any, capital assets. What assets there are will generally be owned by one partner outside the partnership. If capital assets are held inside the partnership, gains will generally only arise on the sale of an asset to an external third party or a total sale of the business. Transfers of shares in assets between partners are relatively uncommon.

6.6 In the event of the total sale of a partnership business, or the sale of an asset inside it, dealing with the gain should be simple. The gain can be computed in the usual way, divided between the partners. Each partner then bears capital gains tax on his or her proportionate share of the gain accordingly to their own positions.[1]

[1] HMRC note that this approach is not supported by statute.

Box 6.A: Capital gains

A and B are in partnership sharing profits 50:50 and owning the assets of the business in the same ratio. New partner C joins, taking 20 per cent of the profits and making a payment for a proportionate share of the partnership assets. The partnership assets include the property from which the partnership trades. A and B have therefore made a disposal of 20 per cent of the property (10 per cent each). Subject to their base costs and any available reliefs, they will be liable for capital gains tax on the gain arising.

6.7 A partner's share of an asset within the partnership is taken to be his proportionate share of the total value of the asset. This is without any discount for the size of the actual share held. This is not stated in the legislation and is instead covered in a statement of practice known as SP D12.

Statement of Practice D12

6.8 This statement of practice was originally issued by the then Commissioners of the Inland Revenue on 17 January 1975. There had already been discussions with the Law Society and the Allied Accountancy Bodies on the capital gains tax treatment of partnerships. This action was somewhat unusual as consultation on taxation matters was nowhere near as common as it is today. The purpose of the statement of practice was to elucidate some issues of general practice which were evolving between the Inland Revenue and the professional bodies. The purpose of the statement was to set down the agreed practice in dealing with section 59 explained in the section above.

6.9 Almost every individual and body we have consulted has made some comment about SP D12, except for small, non-specialist, firms of accountants who do not have to deal with it, and were often unaware of its existence.

6.10 The statement has remained in place, largely unchanged ever since 1975. In 1975 most partnerships were limited to a maximum of 20 partners, international business was rare and the complex structures which have evolved in recent years were unheard of. There are many people who cannot believe that an important area of taxation is governed almost entirely by a statement of practice which is almost 40 years old.

6.11 The statement of practice has had minor updates. First, the statement was extended to apply to limited liability partnerships which meet the requirements of section 59A(1). That is to say those in which any capital gains fall to be taxed on the members. It is expressly stated that it does not apply to those which have ceased to be fiscally transparent because of cessation of trade. In that event gains are chargeable on the LLP as a corporate body and SP D12 no longer has any relevance.

6.12 Further, it has been modified:[2]

- by statement of practice 1/79 – this deals with lump sums and annuities on retirement;
- in 1982 HMRC published Revenue Interpretation 9 – which dealt with rebasing elections and is now redundant;
- by statement of practice 1/89 – which dealt with the application of indexation allowance, and is now largely redundant since the abolition of this allowance for personal gains;

[2] HMRC's views and interpretation of SP D12 can be found in the Capital Gains Manual at CG 27150 -28420.

- by Revenue & Customs Brief 3/08 – this deals with the contributions of capital in specie and the capital gains which might arise on value credited to 'other' partners' capital accounts; and
- by Revenue & Customs Brief 9/09 – limits the application of indexation, introduced by SP 1/89 to corporate partners only for disposals on or after 6 April 2008.

The effect of Statement of Practice D12 now

6.13 As already stated, the vast majority of partnerships will only encounter capital gains tax on the total disposal of a capital asset within the partnership, or else a total sale of the partnership business itself. SP D12 is there to deal with relatively uncommon circumstances in a minority of partnerships.

6.14 Much of it is uncontroversial though, in parts, redundant. For example part of paragraph 12 deals with taper relief on partnership goodwill. Taper relief has now been abolished. There are further references to rebasing elections and market value at April 1965 which are also redundant. Most of the comments we received have applied to paragraph 4 and, to a lesser extent, paragraphs 5 and 6.

6.15 Paragraph 4 deals with changes in partnership sharing ratios. These may occur on a new partner joining or an old partner leaving, as well as internal changes which lead to different shares in capital assets being held. The paragraph seems to have a concessionary effect in that it states that no gain arises where there has been no revaluation of the asset before the change. Where there are no proceeds, the disposal value is treated as a proportionate share of the balance sheet value. Likewise the cost will be a proportionate share of the same balance sheet value.

6.16 Paragraphs 5 and 6 go on to develop this theme where there is an adjustment in the accounts (revaluation of the assets on the balance sheet) or payment outside the accounts.

Perceived problems

6.17 From an early stage in our investigations, it was observed that it cannot be right that such a major area of capital gains tax is governed almost entirely by a statement of practice rather than legislation. Curiously, the same commentators who make such observations seem reluctant to seek a complete legislative solution.

6.18 Some commentators have disagreed with HMRC over how capital gains should be calculated in circumstances to which the terms of SP D12 apply. Expressed concerns have been largely in relation to paragraph 4 of the statement (changes in profit sharing ratio where there is no consideration and there has been no revaluation of assets). To a lesser extent concerns also encompass paragraphs 5 and 6 where there is consideration.

6.19 A typical problem might revolve around a father to son transfer in some way e.g. son is taken into partnership. The son thus gets some goodwill but what is the value? Should there be some sort of rollover to recognise that no cash changed hands? The situation may be worse if father was already a partner with others, to whom he is not related. Who then is making the disposal, is it father to son or all partners to son?

6.20 It is clear that difficult situations have arisen though it has not been possible to quantify how prevalent they are. So far, informal settlements have been reached with HMRC. The issues seem to revolve largely around the treatment of goodwill and intangibles.

6.21 Some of the difficulties derive from acquired goodwill in large professional partnerships. As goodwill of a business merges, there will be increasing cost on the balance sheet. How does this fit with paragraph 4 and the 'no revaluation' principle? At least, where there are many partners and frequent changes, very complex calculations are required. Past problems with goodwill

bought or sold may now have diminished. Accounting standards now require values to be brought in on long term contracts and a lot of goodwill value can be regarded as such value.

6.22 If a partnership buys a business, the goodwill may well be written off. What happens to a subsequent retiring partner – do they get a CGT loss? Can the write off be reinstated if the business is later sold?

6.23 Some HMRC staff agreed with the difficulties of acquired goodwill, even taking the view that comprehension of SP D12 was a major challenge for non-specialists. Their concern was perhaps tempered by the view that gains rarely arose in these cases, so little tax was at risk. Rather, losses were a more frequent outcome.

6.24 Further, some of the major firms have indicated that the practices set out do not fit with 'modern' business structures such as 'nested' partnerships and private equity firms.

6.25 Especial issues do arise though, over which the businesses have no control. For example, following recent changes to accounting policies, LLPs have to amortise assets which can create revaluations of property which might generate capital gains. SP D12 does not allow this to be ignored. It would be good if it did.

6.26 Where differences of opinion have arisen as between HMRC and professional advisers, there has been a marked reluctance to push any issue to litigation. HMRC have taken Counsel's Opinion on the meaning of certain aspects of SP D12. It is likely that professional advisers will have done so too. The problem remains that any opinion then expressed by Counsel only offers limited comfort. SP D12 is just that; an expression of HMRC's view of how the legislation should work in certain circumstances.[3] If any issue is taken to litigation, the Courts will interpret the legislation itself. As that is minimal, no one seems to know what view will be taken. Hence there is reluctance to press the issue for the time being.

6.27 There is a body of opinion that SP D12 only works for larger partnerships because of the work of Customer Relationship Managers and ready access to informed specialists in HMRC. These facilities are not available to smaller general partnerships, although as we have mentioned these smaller partnerships will not require access to these specialists.

6.28 Overall, despite the above concerns, there seems to be general acceptance that SP D12 gives a reasonable result in most circumstances.

Simplification

6.29 It seems to the OTS that there are three options for dealing with SP D12:

1. New legislation could be introduced to reflect the text of SP D12 so far as it is still relevant. This legislation would also encompass practices which have been adopted to circumvent the deficiencies of the statement of practice. Neither HMRC nor practitioners seem enthusiastic about this possibility, and the statement would be extremely complicated to legislate.

2. Leave SP D12 as it is. Given that the vast majority of partnerships are small general partnerships, often holding few capital assets, if any, it is not an issue of major concern. Problems which have arisen at the very top of the spectrum have, hitherto, been resolved by negotiation with HMRC. This status quo could be maintained.

3. Accept that the principle of SP D12 still holds good but rewrite it so that it reflects changes in business ownership and operation since the 1970s.

[3] SP D12 was developed after discussions with professional bodies but at the end of the day it is HMRC's statement and not a joint one; it is HMRC's view rather than an agreed industry-wide statement of position, though most practitioners are content to go along with it.

6.30 The third of these alternatives seems the most appealing but there is a limitation to what might be done. Certainly, it should be possible to remove some of the more arcane language. Additionally, some of the redundant parts, for example, references to market value at 6 April 1965, rebasing elections and taper relief could be removed. However, these do not seem to be the issues that cause problems. Adding new paragraphs to deal with the complexity caused by valuation and goodwill issues may be impossible. Part of the reason is that, in the absence of specific legislation, no one knows exactly how certain capital gains of partnerships would be handled. It may be that there is an element of concession in SP D12. After the decision in R v CIR ex parte Wilkinson[4] HMRC has only limited power to adopt concessionary treatment. Therefore the changes which could be made are likely to be small.

6.31 The best possibility is therefore a hybrid of 2 and 3: SP D12 should remain essentially as it is but rewritten to tidy up the present text, without any substantial changes but dealing with the issues highlighted above and considering the *Wilkinson* issue.

Entrepreneurs' relief

6.32 Some commentators have remarked that they find especial difficulty in applying the entrepreneurs' relief rules to partnerships.

6.33 Whilst the legislation in s169I TCGA 1992 expressly deals with the position of partnerships, it is perhaps felt that this does not adequately cope with some of the more complex business structures that are now in existence.

6.34 One point drawn to the OTS's attention on several occasions has been the position of a LLP which has trading subsidiary companies. The legislation is expressed to deal with trading companies or the holding company of a trading group. The LLP may indeed be in the position of a holding company, and is a corporate body but, seemingly, the LLP member will not qualify for entrepreneurs' relief.

6.35 The underlying rationale for the problem cited in the previous paragraph is that under the Limited Liability Partnerships Act 2000 an LLP is a body corporate which enjoys a legal personality separate from that of its members. However, for the purposes of the Taxation of Chargeable Gains Act 1992 that corporate veil is generally lifted by section 59A so the LLP is treated as a partnership and its members as partners. That treatment helps partners in some ways, but has a downside in the context of entrepreneurs' relief.

6.36 As with all partnership capital gains, entrepreneurs' relief expressly applies to individuals. The relief fundamentally applies to the disposal of a business or an interest in a business. For this purpose section 169I(8) covers interests in partnerships. It may be that, where there are multi-level businesses (nested partnerships) or partnerships with corporate partners, it is not clear what exactly the interest in the business is.

6.37 A form of entrepreneurs' relief can also apply to the disposal of certain assets used in a business where that disposal is "associated" with a disposal of the business itself. Without a disposal of at least part of the business itself, there cannot be an associated disposal attracting entrepreneurs' relief. Again this might turn on the precise structure of the business.

6.38 Entrepreneurs' relief was hastily constructed in April 2008 following the demise of taper relief. It was based on the former retirement relief which was abolished in 2003. Despite the passage of time, the interpretation of entrepreneurs' relief is still heavily based on case law and practice derived from retirement relief. It does not therefore sit readily with modern and developing business practice as cases around disposals of 'part of a business' have shown.

[4] [2005] UKHL 30.

6.39 It seems unlikely that any inherent difficulties will be found in the application of entrepreneurs' relief to small general partnerships. Again difficulties are likely to be limited to a number of relatively complex partnerships.

6.40 We do not see the need for significant simplification measures. It may be that HMRC's guidance in this area could be extended to demonstrate the application of entrepreneurs' relief to certain types of business structure. The 'part of a business' question is not really a simplification issue, though we note that many find it difficult to understand in practice. The issues around LLPs seem similarly to be a product of the legislation but may deserve a review in due course; the following section on inheritance tax also has relevance to the LLP situation.

Administrative issues

6.41 It has been suggested that some partners do not recognise the structure of the business that they are in and therefore their obligations to make correct tax returns. This is especially the case with capital gains. They may be unaware of the mechanism by which gains are to be returned and taxed. Even if they do know of the disposal of a capital asset realising a gain (which may not always be the case) they may think that any taxes are dealt with by the partnership. Any guidance note, which may be issued to assist partners in dealing with their obligations, should specifically address the particular situation of capital gains.

6.42 HMRC in particular commented that it can be difficult to recognise when capital gains have arisen. Return schedule SA 803 only asks for a description of the asset and the gross proceeds. From this, HMRC partnerships processing or compliance have no idea whether a gain has arisen at all, let alone the amount of it. Different gains may arise to different partners owing to length of ownership of the asset in question and different acquisition costs. However, it is not unknown for different partners to return different computations for their share of exactly the same disposal, not because of different circumstances, just because they have made different returns.

6.43 Whilst the onus is on the taxpayer to maintain records in order to deliver a correct self assessment tax return, problems arise with frequently changing partners in large partnerships especially where it is necessary to deal with issues such as acquired goodwill. A pragmatic approach of dealing with the gross gain at the partnership level might improve the situation though there should be clear guidance to ensure that individual partners may still make appropriate adjustments to reflect their personal circumstances.

6.44 HMRC have suggested that the pragmatic approach is incompatible with statute and SP D12. The OTS point, echoed by the sort of firms we have discussed the issue with, is that a different approach might be simpler in practice.

Inheritance tax

6.45 Inheritance tax is a capital tax levied on the estate of an individual on death. On a limited number of transactions, notably the formation of a settlement, it may also be levied on a lifetime transfer of assets.

6.46 Subject to specified exemptions, an individual's estate on death includes all the assets comprised in it. Where there is a chargeable lifetime transfer, its value is equal to the reduction in value of the individual's estate as a result of that transfer.

6.47 Like income tax and capital gains tax, inheritance tax is not levied on partnerships. Where a partner is an individual, inheritance tax may be levied on them or their estate. Inheritance tax will not apply to a corporate partner though there may be consequences for the company shareholders.

6.48 When looking at the individual's estate it is necessary to include any business or interest in a business which is beneficially owned by him. "Interest in a business" includes a share of a partnership. This is looked at globally rather than distinguishing the individual assets comprised in the business. The individual's interest in the business will be their proportionate share of the whole by reference to the capital sharing ratio. In this respect, inheritance tax demonstrates that a partnership is not always transparent for tax purposes. Whilst the individual, or their estate, may be liable for the tax, it is based on the composite share of the business and not the underlying assets.

6.49 The position of an interest in a LLP may be subtly different to that of an interest in a general partnership. Partnerships are not specifically mentioned in the legislation and simply fall to be an interest in a business. On the other hand, s267A Inheritance Tax Act 1984 addresses LLPs. The aim of this legislation is undoubtedly to result in LLPs being treated in the same way as general partnerships. Arguments have been put forward that the legislation around LLPs could be taken to indicate that the LLP members should be treated as holding separate shares in the assets of the business (as opposed to a composite interest in the business as a whole). This is not the view of HMRC.[5]

6.50 Where there are assets held by the partner outside the partnership but used in its business, these will also form part of their estate.

Reliefs

6.51 Whilst the principle of the tax may be quite straightforward, the application of two major reliefs may complicate the issue. These are:

- Business property relief is available on a share in a partnership at the rate of 100 per cent. In other words, property eligible for this relief does not suffer inheritance tax at all. Certain assets owned personally by a partner and used in the partnership business also qualify for business property relief but only at a rate of 50 per cent. This relief is only available where the partnership business does not consist wholly or mainly of 'making or holding investments'; and
- Agricultural property relief applies to, closely defined, agricultural land and buildings. Again there are two rates of relief, 100 per cent and 50 per cent.

6.52 Both reliefs require a period of ownership, usually two years.

6.53 There are many partnerships which are involved in some form of agriculture. Indeed, farming is the commonest trade carried on by partnerships. Many farming partners will own assets which qualify for business property relief or agricultural property relief. The rules for the two reliefs are entirely different and it is entirely possible to have an asset which qualifies for both.

6.54 Because of the rates of relief, it is sensible to structure a business to ensure that the highest rate of relief is available. This has led to a (fairly) recent fashion for what have become known as 'land capital accounts'.[6] The asset owning partner introduces their asset to the partnership but a capital account is created in their favour so that the value of the ownership does not change. The objective of this procedure is usually to make available the property to the business whilst maintaining an indication of who introduced the property. This may also increase the available rate of business property relief from 50 per cent to 100 per cent as the asset is now an asset of the partnership. The reality of this issue is far more complex as there may be different holding arrangements for different pieces of land and there could be successive family generations

[5] See HMRC's Inheritance Tax Manual at IHTM 25094.

[6] This might imply that the circumstances are unique to agricultural landowners. However, the same principle can equally be applied to such assets as office buildings owned by members of professional firms.

involved. Some respondents reported that HMRC take a more belligerent view with partnerships over the distinction between conveyancing details and accounts presentation than they might with a company.

6.55 Once the business interest exists, further assets can be added to increase business property relief without a minimum holding period. Assets held outside the business must separately satisfy the replacement property rules. These issues can become confused where there are asset swaps shortly before death.

6.56 Strange anomalies can arise with non-UK partners involved in UK businesses. Non-UK situs[7] assets are excluded from the charge to inheritance tax if they are held by an individual who is not domiciled here. However, if the individual is a member of a UK partnership then their partnership interest may be within the scope of inheritance tax. If their non-UK situs assets form part of the business interest, they will become part of the estate for inheritance tax. Again a distinction may need to be drawn between traditional partnerships and LLPs where HMRC guidance (IHTM 25094) recommends a reference to HMRC's Technical Group.

Business Property Relief and the question of 'making or holding investments'[8]

6.57 Whilst the comments in the previous paragraphs hold good for general partnerships, following paragraph 6.49 above, it is sometimes suggested that the application of these reliefs to LLPs is rather different. In this case s267A Inheritance Tax Act 1984 deems the LLP member to have an interest in each and every asset held by the LLP whereas the traditional partner has an asset (strictly a 'chose in action') valued by reference to the entire assets of the partnership. On the face of it this could lead to odd anomalies with business property relief which, for LLPs, is still established by the nature of the business, not the assets themselves. However the view expressed by HMRC at IHTM 25094 is clear: there should be no practical distinction between the holding of an interest in a general partnership to the holding of an interest in a LLP.

6.58 The point of this seemingly detailed point becomes clear when some modern business structures are considered. Many partnerships and LLPs will own assets beyond the core business; increasingly LLPs are used in a similar manner to holding companies with a number of limited companies 'underneath' the LLP. If the LLP simply holds the shares in these 'subsidiaries', it is likely to be regarded as 'making or holding investments' and thus ineligible for BPR. There is no equivalent to S105(4)(b) IHTA 1984 which allows a company that is the holding company of a predominantly trading group to be treated as trading.

6.59 If the partnership or LLP is a trading entity but also holds the shares in the 'subsidiaries', the latter may be excepted assets for business property relief purposes, but if the shares are used in the trading business they may qualify for the relief.

6.60 Many venture capital structures include a general partnership, a limited partnership (or two) and a LLP, with one of the LPs holding the 'subsidiaries'.

6.61 In deciding whether an LLP is an investment business, HMRC argue that it is necessary to look through the LLP to see what assets are owned and what is done with them. They do not see a conflict with this approach and the overriding principle that the member's interest in the LLP will be valued as a proportion of the whole business rather than any 'breakup' basis of all the separate assets.

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[7] Situs is in effect where the asset is legally situated.

[8] When the OTS was finalising this report, the ICAEW, CIOT and STEP jointly published an important paper on this subject. The paper aims to provide guidance on some of the technical issues around BPR and LLPs in particular and benefits from significant input and comment from HMRC. This section draws on some of the comments in the paper but the conclusions are the OTS's. However, the paper, published as Taxguide 1/14 by the three bodies is recommended reading for anyone studying this area.

6.62 Concern has been expressed over arrangements, particularly prevalent in the agricultural sector, where a farming partnership is required to invest in a company supplying semen or seeds to ensure they get guaranteed supplies at the optimum prices. The investment in the company may be in an unquoted company but may still not qualify for business property relief as it could be regarded by HMRC as an investment.

6.63 HMRC's stance on the sort of situation in the preceding paragraph has been helpfully clarified in Taxguide 1/14 and the stake in the supplier company may well qualify for relief depending on the precise arrangements. However, many other situations – including the venture capital structures – will probably not attract relief.

Simplification

6.64 The inheritance tax rules as they apply to partnerships, and particularly LLPs, are complex and perhaps misunderstood in some quarters. The basic situation seems to work and be understood, but more could be done to alert businesses and their advisers to the difficulties of owning businesses through partnerships and LLPs. It is to be hoped that the recent Taxguide 1/14 will help in this regard: it deserves to be widely publicised.

6.65 The anomalies that have been drawn to the intention of the OTS will be helped by HMRC's planned revision of its guidance at IHTM 25094 but this will not solve all the concerns business has around the availability of business property relief. We think that there is a strong argument for an equivalent to S105(4)(b) to be available for partnerships and (especially) LLPs, as this reflects how such entities are being used.

6.66 The OTS does not otherwise see this as an area where changes to the scheme of how IHT operates for partnerships are needed. However, we do commend the sort of dialogue that has led to Taxguide 1/14 and feel that engagement should continue: it may be that the case for change in some areas does emerge.

Stamp duty and stamp duty land tax (SDLT)

Stamp duty

6.67 Strictly stamp duty applies to partnerships if they own qualifying underlying securities. However, nobody who has been consulted during our researches could remember a charge arising. It could be an easy simplification to get rid of the charge. However, we understand from HMRC that in certain circumstances a charge can arise.

6.68 Further research is needed to ascertain whether such a step would have any wider implications, perhaps on stamp duty reserve tax.

Stamp duty land tax

6.69 Views on the application of SDLT to transactions involving partnerships have been strongly polarised. There are those who feel that, for the majority, of transactions it works well. At the other extreme are those who feel that the present rules should be scrapped and started again.

6.70 We note that the introduction by Scotland of a Land and Buildings Transaction Tax to replace SDLT is considering carefully whether partnerships can be better dealt with for the new tax.

6.71 HMRC Stamp Taxes took the view that there is little administrative complexity involved in partnerships' SDLT, though they readily accept that the legislation is complicated. Further, as it is a tax on transactions and not persons so in general it should not matter who is making the transaction.

6.72 Partnership transactions may involve the transfer of interests in properties between the partners themselves. Professional advisers take the view that SDLT liabilities on such transactions can become inordinately complicated. This is especially the case with property investment partnerships. It was particularly felt that there are grey areas in establishing what is, or is not, a property investment partnership.

6.73 We've received reports that changes in partnership (income) profit sharing ratios have led to HMRC arguing that there had been a disposal subject to SDLT. This was seen as odd and unacceptable. Surely it is a change in the capital sharing ratio (which may be different) that is the trigger. In any event, if there is no actual cash changing hands, logic would suggest that no SDLT charge should result. This is an area where discussions with the HMRC specialists need to continue to clarify what situations are affected.

6.74 Further and better guidance on the application of the SDLT charge was requested. Generally people argue for a principle that SDLT should only arise if cash changes hands. This was prompted by the example of a partner retiring from a family farming partnership but not taking any value for the land.

6.75 The fundamental dichotomy is that, for the most part, the SDLT legislation treats partnerships as transparent. On the other hand, for dealings between partners and the partnership, SDLT seems to treat the partnership as if it were a person in its own right. This may be a wider issue of making a decision on how partnerships should generally be treated for tax purposes and then the SDLT rules should fit in.

6.76 HMRC have had a significant problem with SDLT avoidance. A small proportion of their stock of SDLT cases relate to partnerships. Recent Court of Appeal decisions may well be a significant step in resolving the situation.[9]

Structure of the legislation

6.77 The SDLT provisions are contained within Finance Act 2003. Almost immediately on introduction, it was widely felt that the original legislation could be very disadvantageous for partnerships. Finance Act 2004 introduced changes specifically applicable to partnerships which are now contained in Sch 15 Finance Act 2003. These do not completely override the general legislation and the first problem in certain instances can be determining which provisions apply in particular circumstances.

6.78 Views differ on whether the commentary contained in HMRC's manuals is clear and comprehensive.

6.79 One point raised on more than one occasion was the different approaches on selling property between partners and partnerships. There could be an entry charge but there could also be an exit charge. The latter seems to be the effect of paragraph 17A sch 15 Finance Act 2003 and has no time limit. It is therefore necessary for advisers to warn of this even though it does not seem to be applied by HMRC. This is in fact an anti-avoidance provision which is nonetheless capable of catching commercial transactions. It was suggested that paragraph 17A is, in fact, redundant in the light of later anti-avoidance legislation in s75A Finance Act 2003, and could be disposed of.

Enquiries

6.80 HMRC raised the point that whenever an SDLT enquiry was made into a partnership it required notifying all partners. This is problematic with large property investment partnerships

[9] HMRC have so far been successful in all four litigated SDLT cases and new legislation has also been passed.

which could have thousands of partners, a lot of whom could be resident outside the UK. It wasn't known whether there were ever any issues with unknown partners.

6.81 For this purpose, the income tax self assessment regime appears to apply. The SDLT enquiry power is in para 12 sch 10 Finance Act 2003 and requires a notice to be given to 'the purchaser'. There is no separate provision for partnerships. HMRC's Manual says 'Similarly, where a stamp duty land tax return...is made by or on behalf of the members of a partnership, each partner is regarded as having made the return or claim.'[10] It may be sufficient that the notice of enquiry is served on the nominated partner.

Simplification

6.82 Fundamentally, it is not immediately obvious when a partnership should be treated as transparent and when it is not. This issue should determine the priority of the specific and general rules. To provide clarity, we suggest that a statement of practice (comparable with SP D12 for capital gains tax) might be introduced. If that is not possible, HMRC's guidance should be strengthened. In particular, it needs to be clear that any SDLT liability will follow a change in the profit sharing ratio and not the capital sharing ratio.

6.83 For investment partnerships which satisfy an appropriate test of there being a wide spread of ownership could the scope for charges be limited? In that event there would be no need to impose a SDLT charge where one partner's proportionate interest changes as a result of joining or leaving the partnership so long as another partner's share increases or reduces.

6.84 Longer term, it does seem that some parts of the legislation relating to partnerships (especially the anti-avoidance provisions) may be confusing and contradictory. Since it was introduced on a piecemeal basis, consideration should be given to revising and consolidating it. The OTS has received a number of suggestions to the effect that the introduction of the General Anti Abuse Rule should facilitate the rationalisation of the anti-avoidance rules but that would be a subject for a separate review.

Simplification

Short-term fixes

- HMRC could usefully publish clearer guidance about which types of partnership structure apply for entrepreneurs' relief and which don't;
- there should be an open invitation to submit genuine business cases that do not appear to qualify for entrepreneurs' relief: this may prompt a separate exercise to review the relief and ensure it properly meets its objectives;
- SP D12 should be tidied up to reflect modern-day business practice, with investigation of the *Wilkinson* issue as a matter of importance;
- HMRC guidance should be clearer on SDLT liabilities following changes in profit sharing ratio; and
- there needs to be a review and update of the guidance on inheritance tax.

[10] See HMRC's Compliance Handbook 23528.

Long-term areas for the OTS to investigate

- we think that there is a strong argument for an equivalent to S105(4)(b) to be brought in for partnerships;
- could stamp duty be abolished for partnerships?
- is there a simpler way of handling stamp duty land tax for partnerships e.g. could paragraph 17A be removed? and
- SDLT should proceed on the principle of 'no cash = no tax'. This is something that should be studied in more detail – not least in terms of whether avoidance opportunities would be created.

7 VAT

7.1 The value added tax (VAT) legislation takes a different view of partnerships to most other taxes. For VAT the taxable person is the one that carries on the business. Consequently, for most purposes, it is the partnership that must deal with VAT matters rather than its constituent partners.

Registering for VAT

7.2 The registration form VAT 1 must be accompanied by form VAT 2. The latter is, in effect, merely a list of all the partners. However, VAT 2 must be signed by all the partners. This is an onerous task for large partnerships with many partners who may be in different locations. For what purpose is this information needed, especially as there is no requirement to report changes of partner? By contrast, a limited liability partnership is not required to complete form VAT 2 because it is treated as a body corporate.

7.3 One reason for telling HMRC about the current partners – and thus showing those who have retired from the firm – is to protect the retired partners from new VAT debts. HMRC also stress that the main reason for the signing of VAT 2 is that the signature is an acknowledgement of the partner's status and the joint responsibility for debts. But it is questionable whether the current route of requiring signed returns is the most efficient way of achieving this.

Group registration and joint ventures

7.4 A couple of bodies consulted said that HMRC will not accept a VAT group of LLPs (which are corporate bodies) but a VAT group of companies is, of course, possible. We have also been told that a VAT group comprising a number of LLPs and a number of limited companies is possible. There are anomalies or at least inconsistencies here.

7.5 The Institute of Chartered Accountants in Scotland has reported some difficulty with Limited Partnerships. In Scotland, a partnership is considered to be a separate legal person. Additionally, Limited Partnerships are more common in Scotland. There is uncertainty as to whether the general partner should register or the partnership itself. Apparently views in HMRC can differ.[1] Recent correspondence to the OTS suggests that HMRC practice may have changed recently and that this may not necessarily accord with policy. Whilst this is not a commonly encountered issue, it would help if there was clarity of advice.

7.6 Further, more than one commentator has said that HMRC insist on treating certain joint ventures as if they were partnerships. This can create confusion when dealing with multinational businesses – just who is a partner? It has been suggested that HMRC are concerned about the option to tax UK property. Possibly they feel that, by having a single registration, a single tax treatment is applicable to all interests in land. Otherwise HMRC might be concerned that if one joint venture person registered and opted to tax and the other did not then there might be scope for avoidance.[2]

[1] See Tolleys Partnership Taxation: 9.29-9.35 explains the distinction as the authors see it.

[2] Again Tolleys Partnership Taxation: 9.42-9.45 explains the distinction though the example comes from a Consultative Committee member.

The new partnership

7.7 A practical issue raised in a number of meetings is the situation where a self employed person goes into partnership (often without realising it at the time). The new partnership should notify HMRC and deregister/reregister. However, this is often missed through ignorance (that they are in a partnership or that there is a need to reregister etc). Penalties may therefore accrue.

7.8 There is the possibility of treating the change as the transfer of a going concern which does not require deregistration/re-registration. (This has the downside of the ongoing business taking on responsibility for past liabilities of the former business.) This is not something that will be well known to these often 'accidental' partnerships and the new partnership that has failed to go through formalities of deregistering/reregistering will not be offered such a route retrospectively.

7.9 The resulting business, if already registered for VAT as a sole trader, will usually carry on making returns and accounting for the VAT due. However, although there is no loss of tax to HMRC, there is an offence and consequent penalty. The penalty is in terms of the 'potential lost revenue'): the amount of tax for which the person is liable as a result of the failure. The law does not currently permit limiting the penalty to the tax lost, if any. In some circumstances a 'special reduction' of the penalty may apply.

A partial exemption point

7.10 It was also suggested that some farming partnerships are increasingly facing partial exemption issues, due to the prevalence of the practice of converting redundant farm buildings into houses that are then let out. It is difficult to make a case for changing the partial exemption limits for this issue but there may well be a need to make sure information is disseminated properly about the implications of partial exemption.

Simplification

7.11 We have had a lot of calls for the form VAT 2 to be withdrawn. The perception is that it is simply a list of partners, though as we have noted HMRC see it as an important statement of responsibilities. We think there should be a simpler, more efficient route, probably based round on-line submission of information, to meet HMRC's needs. Might it be possible to satisfy HMRC needs by submitting a copy of the signed partnership agreement?

7.12 Can HMRC clarify their requirements as regards Limited Partnerships and Joint Ventures? The present published guidance seems unclear.

7.13 Similarly, there needs to be some clear guidance on VAT grouping for LLPs.

7.14 As a longer-term simplification, the penalties around changing a sole trader to a partnership should be reviewed with the aim of making sure they are fair.

A Partnership statistics

A.1 HMRC has provided us with data on partnerships, which we have detailed below. We have repeatedly mentioned data throughout the report; however, a consolidated summary of HMRC's data on partnerships paints an excellent picture of the commercial background to partnerships.

Table A.1: Turnover

	Number of partnerships			
Turnover band	**2008-09**	**2009-10**	**2010-11**	**2011-12**
0	37,200	38,000	42,300	42,200
1 – 10,000	44,000	43,500	43,100	41,600
10,001 – 20,000	32,400	32,200	31,700	30,600
20,001 – 30,000	29,200	28,400	27,800	26,600
30,001 – 50,000	48,000	47,200	46,100	44,200
50,001 – 75,000	46,400	45,400	45,700	44,600
75,001 – 100,000	27,900	27,000	25,800	24,300
100,001 – 250,000	88,900	84,200	81,500	76,700
250,001 – 500,000	49,800	47,100	46,200	44,600
500,000 – 1 million	27,400	26,100	26,000	25,700
1 million – 5 million	18,200	17,700	17,700	17,700
5 million+	1,900	2,200	2,300	2,400
Total	**451,500**	**439,000**	**436,000**	**421,200**

Table A.2: Turnover distribution

Average turnover distribution	**2010-11**	**2011-12**
Mean turnover (£)	341,000	366,000
Median turnover (£)	64,000	63,000

A.2 The mean turnover for partnerships is significantly higher than the median, as the mean is skewed upwards by a relatively small number of partnerships with high turnover. Partnerships are for the most part, very small businesses – 60 per cent of all partnerships have a turnover of less than £100,000. The number of partnerships is the count of all partnerships that HMRC consider to be active which filed an SA800 return by August 2013.

Table A.3: Partner distribution

Number of partners	Number of partnerships		Percentage of partnerships	
	2010-11	2011-12	2010-11	2011-12
Unknown	5,100	3,100	1%	1%
2	344,300	331,600	79%	79%
3	48,700	48,000	11%	11%
4	20,300	20,200	5%	5%
5-10	13,900	14,300	3%	3%
11-20	2,200	2,200	1%	1%
21-50	1,100	1,200	<1%	<1%
51-100	300	400	<1%	<1%
100+	200	200	<1%	<1%
Total	436,000	421,200		

A.3 90 per cent of all partnerships have three or fewer partners. Overall partnerships tend to have very few partners – the number of firms with more than 100 partners is very small.

Table A.4: Agent representation

Represented by agent	Percentage of total partnerships			
	2008-09	2009-10	2010-11	2011-12
Yes	82%	82%	80%	80%
No	18%	18%	20%	20%

A.4 For very small partnerships (those with a turnover below £10,000), agent representation figures are relatively low at 65 per cent. However, this figure rapidly increases with turnover, averaging at 80 per cent. Representation is highest among the group with turnovers between £500,000-£5 million. Above this level, agent representation reduces, probably because the largest businesses depend on in-house expertise.

Table A.5: Limited and limited liability partnerships

Year		Limited Partnerships	Limited Liability Partnerships
2009-10	Registered	1104	9652
	Dissolved	100	7543
2010-11	Registered	1539	10014
	Dissolved	141	5392
2011-12	Registered	2282	11176
	Dissolved	97	4915
2012-13	Registered	2769	10375
	Dissolved	-	5850
Total at end of 2012-13		**23828**	**52961**

A.5 The data above was taken from the Companies House website. It details the number of LPs and LLPs formed and dissolved over the past five years. In total there has been a steep upwards trend in the number of LLPs, which is unsurprising, as the structure was only relatively recently brought into legislation and offers a large amount of flexibility. However, the numbers of LPs may be surprising: these are likely to be investment vehicles in the main.

Corporate partners

A.6 Often we have heard that the use of corporate partners in a partnership is widespread. However, the data we have received has informed us that this is not the case. Of the partnerships operating in the UK, only 23,100 indicated that they had a corporate partner on the SA800. Of these, only 11,900 were mixed member partnerships (partnerships which also had an individual as a partner). The other 11,200 consisted of non-individual partners only. This means that only about 5 per cent of partnerships actually have a corporate partner, and fewer than half of these were mixed member partnerships.

Administrative burdens

A.7 In 2013, HMRC estimated that the total annual cost to partnerships to provide the partnership return (SA800) was £111 million. Overall this represented the single largest obligation an individual business would face, mostly due to the relatively small number of businesses which had to provide it. The burden was mostly shouldered by the smallest businesses – the smallest 75 per cent of the population accounted for 49 per cent of the administrative burden.

Penalties

A.8 Approximately 1,018,000 SA104 pages were submitted in the year 2011-12. This equates to the number of partners in that year. A total of 98,000 penalties were issued for late partnership returns, on 29,000 partnerships. This means that 9.6 per cent of individuals operating in 6.3 per cent of partnerships received a penalty. In the previous year (2010-11), this figure was much higher – 14 per cent received a penalty.

B List of meetings held

B.1 At many of the meetings listed below there were several different people present. There were also several groups consulted not listed below as we did not formally meet them but corresponded by email or spoke over the telephone. We estimate that in total we spoke to around 1,000 people including HMRC staff, practitioners, businesses, and tax advisers; we've also received a wide range of written comments and submissions.

Alternative Investment Management Association

Association of Accounting Technicians

Association of Partnership Practitioners

BDO

Bishop Fleming

Business Services Association

British Venture Capital Association

Cameron and Associates

CBI Tax Committee

Chartered Institute of Taxation: Employment Tax Sub-Committee, Employment Tax Forum

Chartered Institute of Taxation branches: South Wales, Sussex, Hampshire, Hull

David Collison

Deloitte

Federation of Small Businesses

Greaves West Ayre

HMRC: Anti-Avoidance Group, CGT Policy, Inheritance Tax Policy, Local Compliance, Large Business Service, Large Partnerships Compliance, Personal Tax Operations, Stamp Taxes Policy, Tax Administration Policy, Partnerships Processing, Partnerships Technical Support

Ilyas Patel Ltd

Institute of Chartered Accountants in England and Wales

Institute of Chartered Accountants of Scotland

Institute of Financial Accountants

IRIS Software Ltd

James Robertson

Jeremy Nottingham

Large Law Firms

Larking Gowen

Law Society of Scotland

Malcolm Gammie QC

Matthew Hutton

Paul Seal

PricewaterhouseCoopers

Robin Oatbridge & Co

Society of Trust and Estate Practitioners

Society of Professional Accountants

Sopher & Co

Stamp Tax Practitioners Group

UK200 Group

International comparisons

Summary of international treatment

C.1 Below we have provided brief detail into how partnerships are treated by different countries. For this review partnership law and tax information was gathered from the United States of America, Sweden, Ireland, Australia and Canada, amongst others. It has not been replicated here; instead a summary of the key differences has been given here.

C.2 In most cases the approach towards partnerships mirrors that of small businesses of the self-employed (sole trader). Several countries treat partnerships in dramatically different ways to the UK. However, many countries have been inspired by the UK Partnership Act of 1890, e.g. in the case of Ireland, existing pre-independence legislation (UK based) was simply brought forward.

C.3 The current Irish situation is a development of the inherited legislation, and in particular there is the Taxes Consolidation Act 1997, and The Finance (No. 3) Act 2011 Edition – Part 43, the section dealing with partnerships. The definition is a useful reminder of their approach to partnerships.

Box C.1: Partnerships and European Economic Interest Groupings

The general rules around partnerships also apply to European Economic Interest groupings (EEIGs). The broad effect of this is that, in the case of a trade or profession carried on by two or more persons in partnership, each partner's share of the profits or losses are to be treated for tax purposes as if they were profits or losses of a separate business carried on solely by that partner. The notional separate business of a given partner is to be regarded as having been commenced when he/she became a partner and, if he/she ceases to be a partner, as permanently discontinued when he/she so ceases. This procedure also applies in the case of an European Economic Interest Grouping (EEIG) formed in accordance with Council Regulation (EEC) No. 2137/85 of 25 July, 1985 (OJ L 119 31.10.1985 p.1) that is, the profits or losses resulting from its activities are taxable only in the hands of its members.

C.4 There has been a trend towards the gradual unification of partnership law, so that one Act now covers partnerships, limited partnerships and limited liability partnerships, which is evident in the U.S. and Australia so far.

C.5 The tax treatment of partnerships also varies internationally. For example, in Sweden the partnership exists to generate profits, but no separate return is used for partnerships it is up to the individual tax payer to return the information as if he or she were self-employed.

D Consultative committee members

Alan Hartley	Mactaggart & Mickel and the Institute of Chartered Accountants of Scotland
Andrew Disley	Allen & Overy LLP
Chas Roy-Chowdhury	Association of Chartered Certified Accountants
Gary Richards	Berwin Leighton Paisner LLP
Liz Bridge	Construction Industry
Martyn Ingles	Ingles Tax and Training
Matt Henty	HM Treasury
Michael Parker	National Farmers Union
Rosemary Danielian	HM Revenue and Customs
Sue Cave	Federation of Small Businesses
Will Silsby	Association of Accounting Technicians

E Overview of legislation

E.1 Below we have set out a list detailing the main legislation specific to partnerships (not including sole traders) based on contents and pages of Acts. This list shows how partnerships legislation is very spread out over a large number of Acts.

Tax	Statute	Description	Length (pages)
General	PA 1890	Partnership Act 1890 – sets out what a partnership is	
General	LPA 1907	Limited Partnership Act 1907 – introduces rules for limited partnerships	
General	LLPA 2000	Limited Liability Partnerships Act 2000 – has rules for LLPs	4
General	LLPA (NI) 2002	The Limited Liability Partnerships Act (Northern Ireland) 2002	
Corporation tax	CTA 2009, S80	Redundancy payments – rules for cases involving partnerships	0.2
Corporation tax	CTA 2009, S380-385	Loan relationships rules for partnerships involving companies	2
Corporation tax	CTA 2009, S467	Loan relationships – connections where partnerships are involved	0.3
Corporation tax	CTA 2009, S474	Loan relationships – "major interest" connection where partnerships involved	0.7
Corporation tax	CTA 2009, S619-621	Derivative contracts – partnerships involving companies	1
Corporation tax	CTA 2009, S840	Intangible assets – related parties rules for partnerships	0.2
Corporation tax	CTA 2009, S1256-1273	Corporation tax rules for partnerships	5.5
Corporation tax	CTA 2010, S55-61	Corporation tax losses for limited partners and members of LLPs	3
Corporation tax	CTA 2010, S234	Community investment tax relief – exclusion for cost of share in partnership	0.2
Corporation tax	CTA 2010, S409-431	Sales of lessors – leasing business carried on by company in partnership	13
Corporation tax	CTA 2010, S887-889	Leasing plant and machinery – restriction on losses in leasing partnerships	1.2
Corporation tax	CTA 2010, S958-962	Transfer of loss relief within partnerships	1
Corporation tax	CTA 2010, S1135	Definition of property investment LLP	0.2
Corporation tax	TIOPA 2010, S332B-C	Tax treatment of financing costs, available amount for partnerships	0.8
Corporation tax	CAA 2001, S261A	Capital allowances – leasing partnerships	0.3

Income tax and corporation tax	CAA 2001, S263-267	Capital allowances – partnerships and successions	3.5
Income tax and corporation tax	CAA 2001, S557-558	Capital allowances – effect of partnership changes	0.5
Income tax	ITEPA 2003, S52	Payment of workers through intermediaries that are partnerships	0.4
Income tax	ITTOIA 2005, S164	Intermediaries treated as making employment payments – rules for partnerships	0.3
Income tax	ITTOIA 2005, S846-863	Income tax rules for partnerships	7.2
Income tax	ITA 2007, S62	Income tax losses for partners	0.5
Income tax	ITA 2007, S77-78	Restriction on sideways loss relief for partners	0.7
Income tax	ITA 2007, S102-116	Restriction on sideways loss relief for certain partnerships	9.5
Income tax	ITA 2007, S257DH	Seed enterprise investment scheme – no partnerships requirement	0.2
Income tax	ITA 2007, S398-400	Income tax relief for interest on loans for investing in partnerships	1.5
Income tax	ITA 2007, S409	Income tax relief for investing in partnerships – successions	0.3
Income tax	ITA 2007, S790-809	Avoidance involving trading losses	8.3
Income tax	ITA 2007, S809AZF	Transfers of income streams from partnership shares	0.3
Income tax	ITA 2007, S809BZA-809BZS	Avoidance involving finance arrangements	7
Income tax	ITA 2007, S859	Deduction of tax at source – declarations of non-UK residence by Scottish partnerships	0.4
Income tax	ITA 2007, S932	Deduction of tax at source – definition of qualifying partnership	0.1
Income tax	ITA 2007, S937	Deduction of tax at source – exempted payments for partnerships	0.3
Non-tax	PA 1890	Legal framework for partnerships	4
HMRC administration	TMA 1970, S12AA-12AD	Tax returns of income and gains for partnerships	4
HMRC administration	TMA 1970, S28B	Completion of an enquiry into a partnership tax return	0.3
Capital gains tax	TCGA 1992, S59 - 59A	Capital gains tax rules for partnerships and LLPs	1.3
Capital gains tax	TCGA 1992, S169A	Capital gains on cessation of trade by an LLP	0.2
Capital gains tax	TCGA 1992, S211A, Sch 7AD	Capital gains of insurance company from venture capital partnership	4
Capital gains tax	TCGA 1992, S271C	UK representatives of non-UK residents – trades carried on in partnership	0.3
Income tax	FA 1993, Sch 20A paras 6-8	Lloyd’s underwriters – transfer of business to a successor partnership	1

Corporation tax	FA 1998, Sch 18 para 12	Corporation tax return rules for companies in partnerships	0.2
Corporation tax	FA 1998, Sch 18 para 51D, F	Corporation tax returns for companies in partnerships – error or mistake claims	0.6
Income tax	SI 2005/2017	Partnerships (restrictions on contributions to a trade) Regulations 2005	2
Income tax	SI 2006/1639	Partnerships (restrictions on contributions to a trade) Regulations 2006	1
Inheritance tax	IHTA 1984, S119	Agricultural property relief, occupation by company or partnership	0.1
Inheritance tax	IHTA 1984, S267A	LLPs	0.2
Stamp duty land tax	FA 2003, S65	Relief on incorporation of an LLP	0.4
Stamp duty land tax	FA 2003, S104, Sch 15	Application of SDLT to partnerships. Amended in FA 2004, 2005, 2006, 2007, 2008	19
Stamp duty land tax	F(No 3)A 2010, Sch 12 para 34C	Recovery of unpaid SDLT	0.2
Penalties	FA 2007, Sch 24 para 20	Penalties for inaccurate partnership returns	0.2
Insurance premium tax	FA 1994, S62 (1)	Power to make regulations for IPT for partnerships	0.1
Insurance premium tax	SI 1994/1774 para 4A(2)	Specified form for IPT for partnerships	0.1
Insurance premium tax	SI 1994/1774 para 5(4)(d)	IPT – changes in particulars for partnerships	0.1
Insurance premium tax	SI 1994/1774 para 10(3)	IPT – who is responsible for IPT obligations for partnerships	0.2
Landfill tax	FA 1996, S58(1)	Power to make regulations for landfill tax for partnerships	0.1
Landfill tax	SI 1996/1527 para 4(3)	Specified form for landfill tax for partnerships	0.1
Landfill tax	SI 1996/1527 para 5(4)(b)	Landfill tax – who is responsible for changes in particulars for partnerships	0.1
Aggregates levy	FA 2001, S36	Aggregates levy rules for partnerships	0.8
Aggregates levy	SI 2001/4027 para 12	Aggregates levy – registration rules for partnerships	0.2
Climate change levy	FA 2000, Sch 6 para 56(4)	Climate change levy – registration rules for partnerships	0.1
Climate change levy	SI 2001/7 para 2(2)	Climate change levy – specified form for partnerships	0.1
Climate change levy	SI 2001/7 para 12	Climate change levy rules for partnerships	0.2
VAT	VATA 1994, S45	VAT rules for partnerships	0.5

F About partnerships

What is a partnership?

F.1 According to the Partnership Act 1890, a partnership is 'the relation which subsists between persons carrying on a business in common with a view of profit'.

F.2 A partnership is the simplest form of business structure for more than one person to engage in. The partnership is not, in general law or tax law, a separate entity (though see below regarding Scottish partnerships), unlike a company. The 'constitution' of a partnership is the partnership agreement, which in principle defines how the business should be carried on, what it should do and how profits and losses should be divided between the partners. In the absence of a separate agreement between the partners, section 24 of the 1890 Act sets out the way in which the partners' interests in partnership property and their rights and duties in relation to the partnership will be determined.

F.3 As the 1890 Act implies, a partnership is where two or more persons carry on business together with the aim of making a profit. In this context 'person' means a legal person so it can include non-individual persons such as companies. The members of partnerships are referred to as 'partners'; when referring specifically to partnerships governed by the 1890 Act, our report uses the term 'general partnerships'.

F.4 Another form of business arrangement is the 'joint venture'. This is typically between two people (or companies), often for a limited period to undertake a particular activity. However, not all joint ventures will be partnerships and a joint venture is not a form of partnership.

F.5 In addition to general partnerships, there are two specialised commercial vehicles which fall under the heading of 'partnership'. These are limited partnerships (LPs) and limited liability partnerships (LLPs). The key distinction between these two partnerships and general partnerships is a matter of liability. General partnerships have unlimited liability: the partners are fully liable for all the debts of the partnership, including their personal assets. With LPs under the LPA 1907, one (or more) partners have limited liability, but such 'limited partners' cannot participate in the management of the firm. In an LLP, all 'members' (they are not partners as such) have limited liability, and are hence not liable for the debts incurred by the LLP beyond the capital that they have invested in the firm.

F.6 Limited partnerships are partnerships and are governed by the provisions of the1890 Act as well as the LPA 1907. In contrast, LLPs are not partnerships. They are bodies corporate, which are treated like partnerships for specified tax purposes.

F.7 The remit of this report also extends to Scottish partnerships, which include general and limited partnerships covered by Scots law. Unlike general partnerships, Scottish partnerships are separate legal persons. Most of the commentary in this report on partnerships can also apply to Scottish partnerships; however, the key differences are not extensively covered here.

Why partnerships?

F.8 From a commercial perspective it is easy to see why partnerships are widely used. If two people wish to work together, then a partnership presents the least administratively burdensome

way. Formalities are minimal, it is flexible; it can be dissolved easily and/or others brought in. The main alternative is to incorporate the activity and operate as a company. That brings administrative burdens – but does potentially offer the key advantage of limited liability.

F.9 Partnerships are very flexible commercially. A key point is simply that the partners depend on the profits for their reward: so if the firm does well, the partners automatically share; at the same time, a bad year does not create problems of still having to pay the proprietors – the partners share in the tough time. In simple terms, the partners identify with the business and are motivated accordingly. This factor remains important for even the largest partnerships.

F.10 It is comparatively easy to bring new partners into a partnership, which facilitates incentivising employees and succession planning. The ability to change profit share provides a very simple way to incentivise some partners, as their share can be increased or decreased.

F.11 The problems of unlimited liability for partners led to calls for ways of limiting the liability of partners in the 1990s. Operating through a company was not always possible for some professionals and this resulted in the LLP Act. Although the expectation was that the main users would be large accounting firms (who faced significant threats of lawsuits), in fact the LLP has been widely adopted by accountants, lawyers, tax advisers, surveyors, architects and many other professional businesses of all sizes. The vehicle allows the firm to retain the partnership ethos whilst guarding against 'catastrophe' claims.[1]

F.12 The growth of LLP businesses is illustrated in the figures in Annex A. It is also interesting to note the growth in LPs – a vehicle that has been rediscovered of late. Both LPs and LLPs have become widely used in investment arrangements, often linked to venture capital. The driver is a combination of flexibility, simplicity and allowing limited liability status where needed. The OTS was taken through a number of arrangements by the BVCA; one point that struck us was how international these arrangements are and how the UK's partnership laws have undoubtedly facilitated the growth of this useful component of the 'City's' offering in what is a very competitive marketplace.

F.13 A further development in business practices has been the use of corporate partners. The main driver for this tends to be allowing a corporate 'wrapper' around some of the business activities – often the employment of staff. The corporate may also be able to access reliefs not available to individual partners in partnerships (for example, intangibles). There are some more specialised situations, for example farming businesses often have no choice but to be in partnership with a corporate partner. The corporate represents the landlord who has let the partnership its land; the landlord is protected through limited liability from the debts of the firm and can recover its land by voting to dissolve the partnership. This type of structure features regularly in Scotland.

F.14 A corporate member may also offer the chance for the firm to have some profits taxed at corporate rates rather than full income tax rates and retain those profits for working capital. Such profits would be taxed to income tax in full when paid out, of course.

F.15 It must also be acknowledged that partnerships – mainly LLPs – have been used for tax planning and avoidance. Film investment structures are an example of this phenomenon.

Partnership or company?

F.16 Any new business will need to consider the best format for its operations. The question of 'should I incorporate' is something all accountants and tax advisers who deal with small

[1] Though such a claim could wipe out the firm including the investments made in it by the partners, and also bankrupt a partner found to be at fault. The other partners' private assets are not at risk, however.

businesses meet regularly. Tax considerations play a part, but there are many other relevant factors to consider. A summary of the main items:

Issue	Partnership	Company
Liability	Unlimited liability	Limited to capital – but this protection n is often eroded by the need to give personal guarantees
Constitution	Can be informal; partnership agreement flexible. No requirements for accounts, return etc	Legal requirements; articles of association, statutory books etc. Requirements around accounts and annual return
Governance	Subject to the partnership agreement, unanimous agreement of partners needed	Majority of voting shares decide
Profit retention	In principle all profits distributed	Separate decision about distribution via dividends
Tax	Income tax at all rates; lower NICs (though less benefit entitlement)	Corporation tax (income tax on dividends; NICs on pay for employees and employer
Incentivising employees	Partnership possibilities	Share schemes – including tax-advantaged schemes
Succession planning	Generally involves bringing in new partners; profit sharing ratios can be flexible	Easier to pass on some shares without surrendering control or giving away a major part of the business

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